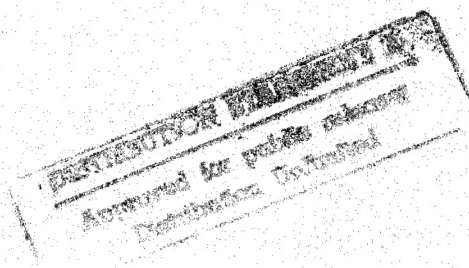
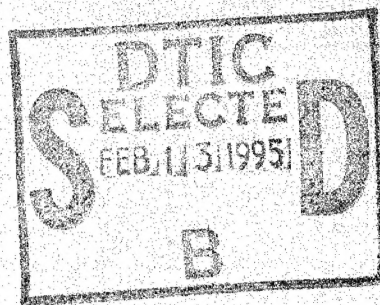


GAO

April 1992

EMPLOYEE BENEFITS

Improved Plan Reporting and CPA Audits Can Increase Protection Under ERISA



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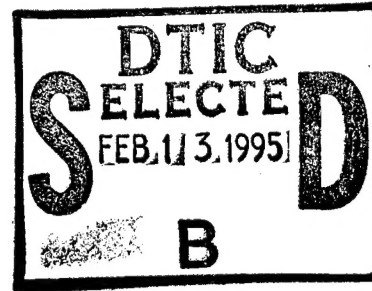
Comptroller General
of the United States

B-246064

April 9, 1992

The Honorable J. J. Pickle
Chairman, Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

The Honorable Pat Williams
Chairman, Subcommittee on
Labor-Management Relations
Committee on Education and Labor
House of Representatives



In response to your Subcommittees' requests, we are providing information on (1) audits of employee benefit plans and (2) the evidence supporting the November 1989 study by the Department of Labor Office of Inspector General that criticized these audits. In this report, we identify requirements for employee benefit plan audits, describe the results of our review of employee benefit plan audits, and discuss scope limitations in these audits. We also identify ways to enhance plan reporting and audits.

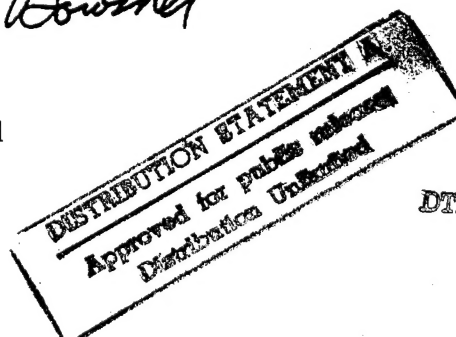
This report recommends that the Congress amend the Employee Retirement Income Security Act of 1974 to require full scope audits of employee benefit plans and to require plan administrators and independent public accountants to report on how effective an employee benefit plan's internal controls are in protecting plan assets. These internal controls should be a key safeguard in protecting the interests of plan participants and the government as an insurer of some plans.

We are sending copies of this report to the Chairmen of various Congressional Committees and Subcommittees, the Secretary of Labor, and the Chairman of the American Institute of Certified Public Accountants. Copies will be available to others on request.

This report was prepared under the direction of David L. Clark, Director of Legislative Reviews and Audit Oversight, who may be reached on (202) 275-9489 if you or your staffs have any questions. Other major contributors are listed in appendix IV.

A handwritten signature in cursive script that reads "Charles A. Bowsher".

Charles A. Bowsher
Comptroller General
of the United States



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Executive Summary

Purpose

In November 1989, the Department of Labor's Office of Inspector General (IG) identified significant deficiencies in audits of private employee benefit plans. These findings generated congressional concerns about the protection of American workers' benefits and the risks associated with inadequate plan audits. As a result, the chairmen of the House Subcommittee on Oversight, Committee on Ways and Means, and the House Subcommittee on Labor-Management Relations, Committee on Education and Labor, asked GAO to identify problems in the performance of plan audits. In so doing, GAO also identified various ways to improve plan reporting and audits and, thus, further protect the interests of plan participants.

Background

The Employee Retirement Income Security Act of 1974 (ERISA) established various safeguards to protect the assets of private employee benefit plans and to ensure that plan participants receive benefits to which they are entitled. Under ERISA, the Department of Labor requires that an employee benefit plan (plan) having 100 or more participants obtain an annual financial statement audit by an independent public accountant. Audits of employee benefit plans are a key safeguard for protecting much of about \$1.75 trillion in assets held by plans. Also, ERISA established the Pension Benefit Guarantee Corporation which insures about 95,000 defined benefit pension plans.

ERISA established fiduciary standards for plans and required that annual reports on plan operations, including an annual audit, be furnished to the Department of Labor and made available to plan participants. According to Labor's Office of Inspector General, ERISA cannot be materially enforced without plan audits.

In November 1989, the Labor IG reported that 64 of 279 plan audits it reviewed violated at least one auditing standard. Labor referred 14 of these 64 plan audits to the American Institute of Certified Public Accountants (AICPA), a voluntary professional association which provides guidance on auditing, for investigation of serious audit deficiencies. GAO reviewed 25 plan audits randomly selected from the remaining 50 in order to assess the reasonableness of the IG's criticisms.

In the last several years, GAO has become increasingly concerned about the inadequacies of audits which do not specifically address an entity's internal controls and compliance with applicable laws and regulations. Legislation enacted at the end of 1991 adopted GAO recommendations to require

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reforms to deal with inadequacies in financial statement audits of insured depository institutions, thereby helping to protect the government in its capacity as insurer of deposits in such institutions.

Results in Brief

Over a third of the 25 plan audits reviewed by GAO had audit weaknesses so serious that their reliability and usefulness were questionable. In some cases, the auditors failed to adequately test investments amounting to millions of dollars or test the appropriateness of millions of dollars in payments to insurance companies. These deficiencies indicate that auditors were sometimes unfamiliar with ERISA requirements and the special considerations associated with auditing employee benefit plans. Although the AICPA revised its guidance for performing plan audits in 1991, additional changes in the guide are needed.

Further action is needed to adequately protect the interests of plan participants. Legislation should be enacted to eliminate limited scope audits, which are presently permitted by ERISA. Legislation should also adopt, with appropriate modifications, the model reforms recently enacted for federally insured depository institutions. The legislation should require reporting on the adequacy of internal controls by plan administrators and auditors, provide for direct reporting to the Department of Labor of fraud and serious ERISA violations, and require peer review for plan auditors. These changes would enhance the value of plan audits, encourage better plan management, and, ultimately, better protect the interests of plan participants and the government.

Principal Findings

Failures by Auditors to Properly Audit

GAO evaluated 25 of the plan audits previously reviewed by the IG to determine if they were properly performed and if the IG's criticisms were reasonable. GAO found that nine of the plan audits did not satisfactorily comply with auditing standards because they had problems that were so severe that their reliability and usefulness were seriously diminished. The AICPA identified many of the same types of violations during its investigation of the 14 plan audits referred by Labor. For these reasons, GAO concluded that the IG's findings were generally reasonable.

The predominant problems in the plan audits were insufficient audit work or the lack of working paper evidence to prove that audit work was

sufficient to support the unqualified opinions expressed by some auditors. In one case, for example, the working papers showed no evidence of tests for virtually all plan disbursements used to purchase insurance policies for plan participants. Many deficiencies involved the specialized auditing procedures intended to provide evidence about assets held by plan trustees, actuarial valuations, or the appropriateness of plan participant benefits. GAO concluded that these problems demonstrated that some auditors lacked industry knowledge and were not aware of ERISA requirements. The November 1989 IG study noted a similar problem of limited understanding.

Initiatives Taken to Improve Audit Quality

In response to the IG study, the AICPA has initiated various actions to publicize plan audit problems and better educate auditors about the audit procedures and requirements for plan audits. The AICPA also expanded its guidance on conducting plan audits. GAO believes that these initiatives are important steps toward ensuring that auditors have the expertise needed to improve the usefulness and reliability of future plan audits. However, additional changes need to be made to the audit guide to, among other things, clarify audit requirements and emphasize the need for specialized industry knowledge.

Reporting and Auditing Requirements Under ERISA Need Strengthening

GAO believes that legislation is needed to strengthen reporting and auditing requirements for plans and to further protect the interests of plan participants. Legislation should include several provisions.

First, the legislation should eliminate the limited scope audit provision from ERISA. This provision allows plan administrators to exclude from the scope of the audit investments held by certain regulated institutions, such as banks and insurance companies. Eliminating the limited scope provision from ERISA would subject all plan assets to audit and decrease vulnerabilities associated with plan assets. GAO found that over 25 percent of the total \$126 million in plan assets covered by the 25 plan audits it reviewed were excluded from examination under ERISA's limited scope provision.

Second, the legislation should require reports on the effectiveness of internal controls by the plan administrator and the auditor. Plan administrators have a fiduciary responsibility to operate plans in the best interest of plan participants. Requiring plan administrators to prepare and sign reports on the effectiveness of the internal control structure, including

controls for compliance with laws and regulations, and then providing the reports to regulators, participants, and others, would help ensure that adequate controls are established and maintained.

Requiring auditors to review plan administrators' reports on internal controls would help protect plan participants' interests by helping to ensure that plans maintain strong internal controls, adhere to laws and regulations, and properly report their financial condition. Such reviews could also provide early warnings of potential problems. Similarly, reviews of internal control reports would benefit the federal government, which, as insurer of defined benefit pension plans, faces a significant liability if plans with large unfunded liabilities terminate.

Further, GAO believes that auditors have a basic public responsibility and must consider the government's interests when auditing federally insured employee benefit plans. Auditors should be required to play a more active role in assisting regulators and plan administrators in identifying, preventing, and correcting problems in financial reporting and internal controls. This expansion of the auditor's role is in keeping with GAO's belief that auditors must recognize that they have greater responsibilities when accepting audit engagements for federally insured entities. Similar provisions, which are important reforms in auditing and reporting for federally insured financial institutions, were recently enacted in the Federal Deposit Insurance Corporation Improvement Act of 1991 (Public Law 102-242).

Third, legislation should require auditors to report fraud and serious ERISA violations directly to the Department of Labor. While both plan participants and Labor have significant interests in ERISA violations, there is no requirement in ERISA or Labor's implementing regulations that either be promptly and directly informed by the auditor when fraud or serious fiduciary breaches are discovered. Such a provision would increase protection of plan participants.

Fourth, legislation should require all audit firms which audit employee benefit plans to obtain a peer review. Peer review programs essentially entail the verification by other audit firms that the firm reviewed has a system of quality controls that reasonably ensures that audits meet established standards. Requiring all audit firms which audit employee benefit plans to participate in a peer review program that includes at least one plan audit would help ensure that audit firms performing plan audits adhere to auditing standards and perform quality audits.

Recommendations

GAO makes recommendations to the Department of Labor, the AICPA, and the Congress in chapters 2, 3, and 4. Of particular importance are the legislative recommendations that the Congress amend ERISA to: (1) eliminate the provision that permits limited scope audits, (2) require reports by plan administrators and auditors on internal controls, (3) require reporting by auditors of fraud and serious ERISA violations, and (4) require peer review of auditors conducting plan audits.

Agency Comments

Both the Secretary of Labor and the Chairman of the Board of the American Institute of Certified Public Accountants commented on a draft of this report. (See appendixes II and III.)

Labor agreed with many of GAO's recommendations but expressed concerns with the recommendations on internal control reporting and direct reporting to Labor of serious ERISA violations. However, Labor did agree that significant internal control weaknesses can lead to fraud and abuse of plan assets. Labor stated that it is currently assessing alternative approaches for the identification and reporting of significant internal control weaknesses. With respect to direct reporting, Labor is considering whether plan administrators should be required to report to Labor information related to certain criminal acts involving employee benefit plans covered by ERISA. However, this does not utilize the resource of the independent auditor to help protect against criminal acts by plan administrators.

The AICPA stated that it is considering many of GAO's recommendations. It also stated that it supports cost beneficial efforts and suggestions to increase the protection of plan participants but has concern about creating unrealistic expectations relative to the role and work of independent accountants. GAO believes implementing its recommendations would allow the profession to better meet the public's existing expectations. The AICPA expressed serious concerns with direct reporting of fraud and serious ERISA violations to Labor because of its view of client confidentiality. GAO disagrees with this view and believes the auditor should be required to report fraud and serious ERISA violations when the plan administrator fails to do so.

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Abbreviations

AICPA	American Institute of Certified Public Accountants
CPA	certified public accountant
ERISA	Employee Retirement Income Security Act of 1974
FASB	Financial Accounting Standards Board
GAAP	generally accepted accounting principles
IG	inspector general
IRS	Internal Revenue Service
PBGC	Pension Benefit Guaranty Corporation

Introduction

In 1988, the latest year for which data are available, an estimated 5.2 million employee benefit plans (plans) covered by the Employee Retirement Income Security Act of 1974 (ERISA) had assets of about \$1.75 trillion. These plans fell into three general categories.

- Approximately 146,000 were defined benefit pension plans which provide a set level of benefits based on such factors as years of employment, age, and compensation received.
- Approximately 585,000 were defined contribution pension plans which have separate accounts for each participant. Contributions are invested, and benefits are based on the amounts in each participant's account.
- Approximately 4.5 million were health and welfare plans which provide, for example, medical and dental benefits and insurance policies. These benefits are paid from accumulated contributions and income or through the purchase of insurance policies.

ERISA Safeguards

ERISA was enacted to protect plan assets from mismanagement, fraud, and abuse and to ensure that plan participants receive the benefits to which they are entitled. To protect plan participants, ERISA established fiduciary standards for plan operations. ERISA defines a fiduciary as anyone who exercises any discretionary authority or control over management or administration of a plan or the management or disposition of its assets; gives investment advice (for compensation) with respect to any property of a plan; or has any authority or responsibility to do so. ERISA also established the Pension Benefit Guaranty Corporation (PBGC), which guarantees payment of most private sector defined benefit pensions if plans become unable to pay.¹

Prior to enacting ERISA, the Congress found that the interests of plan participants were not adequately protected, among other reasons because plan participants lacked information about their plans. To address this problem, ERISA established reporting and disclosure requirements for plan administrators. These include providing plan annual reports to regulators and making these annual reports available to participants.

For plans having 100 or more participants, the annual reports ordinarily include a Form 5500, financial statements, schedules required by ERISA or

¹ERISA excluded from PBGC insurance coverage some defined benefit pension plans, such as government plans, and some church and fraternal organization plans.

Labor regulations (ERISA schedules), and a report of an independent public accountant with respect to such financial statements and schedules. A Form 5500 contains general information on a plan's sponsor, funding arrangements, participants, and financial operations. The ERISA schedules disclose, among other things, information on investment activities, loans or leases in default, and transactions that may involve conflicts of interest. Appendix I provides details on reporting and disclosure requirements under ERISA.

Under ERISA, Labor requires each plan having 100 or more participants to obtain an annual plan audit, which must be conducted by an independent, qualified public accountant, generally a certified public accountant (CPA). To meet this requirement, an administrator of such a plan must hire an auditor, on behalf of all plan participants, to audit and report on plan financial statements and ERISA schedules. The plan administrator may exercise ERISA's limited-scope provision, which allows the plan administrator to exclude plan investments held by certain regulated institutions such as banks and insurance companies from the scope of the audit.

The Department of Labor is primarily responsible for enforcing ERISA fiduciary standards, which require that plans be operated in the participants' best interests. In this regard, Labor conducts investigations to ensure that plan administrators comply with ERISA fiduciary standards and that plan information is available to participants and other interested parties. The Internal Revenue Service (IRS) is responsible for administering and enforcing ERISA's vesting, participation, and funding requirements and determining whether plans qualify for favorable tax treatment under the Internal Revenue Code. IRS accomplishes this by reviewing plan designs and examining pension plan returns and operations for compliance with tax laws and regulations.

The Role of Auditing

As we testified in July 1990,² plan audits are a prime means of ensuring that plans comply with ERISA safeguards. By scrutinizing and reporting on plan transactions and operations, such audits (1) make key information available to plan participants so they can monitor their own plans and (2) provide discipline by evaluating whether plan administrators have fulfilled their fiduciary duties and complied with laws and regulations.

²Audits of Employee Benefit Plans Need to Be Strengthened (GAO/T-AFMD-90-25, July 24, 1990).

Plan audits also can help regulators ensure that plan participants' interests are protected. According to Labor, annual reports—including audit reports—provided by plans, are its most valuable source of information for targeting investigations because these reports may contain information indicative of ERISA violations. According to Labor's Office of Inspector General (IG), Labor investigates less than 1 percent of all plans because of limited staff, and ERISA cannot be materially enforced without these plan audits.

Labor IG Study

In November 1989, the Labor IG issued a study³ which concluded that 64 of 279 randomly selected plan audits violated at least one generally accepted auditing standard. The IG further reported that inadequate audit opens the door for fraud and abuse, such as disbursements to ineligible individuals or excessive administrative costs.

Labor referred 14 of the 279 plan audits in the IG's sample, or 5 percent, to the American Institute of Certified Public Accountants (AICPA) for what it termed "egregious disregard" of professional standards. In response, the AICPA independently investigated these 14 plan audits. The AICPA also reviewed the working papers supporting the IG study to (1) analyze the audit deficiencies noted by the IG and (2) identify ways to reduce their occurrence in the future.

The IG's criticisms prompted congressional concerns about whether plan audits provide the protections intended by ERISA and raised serious questions regarding the security of about \$1.75 trillion in plan assets. Similarly, these criticisms raised questions about PBGC's financial future. In fiscal year 1990, the PBGC insurance funds guaranteed about 95,000 defined benefit pension plans for 39 million participants.

In January 1991, we stated⁴ that PBGC's financial future depends on, among other things, the amount of future liabilities that PBGC may incur as a result of weaknesses in plan oversight, including limited scope audits. To the extent that plan audits provide early detection and reporting on plan

³Changes Are Needed in the ERISA Audit Process to Increase Protections for Employee Benefit Plan Participants, U.S. Department of Labor, Office of Inspector General, 09-90-001-12-001 (Washington, D.C.: November 9, 1989).

⁴Our audit opinion is contained in Pension Benefit Guaranty Corporation 1990 Annual Report, Pension Benefit Guaranty Corporation (Washington, D.C.: September 1990), pp. 46-47.

problems, these audits can improve plan management and supervision and ultimately reduce the risk of claims against PBGC insurance programs.

Objectives, Scope, and Methodology

The November 1989 IG study prompted the Chairman of the House Subcommittee on Oversight, Committee on Ways and Means, and the Chairman of the House Subcommittee on Labor-Management Relations, Committee on Education and Labor, to ask us to identify problems in the performance of plan audits. The objectives of our review were to

- identify requirements for plan audits,
- identify problems in the performance of plan audits,
- assess the reasonableness of the IG's criticisms of plan audits, and
- evaluate actions taken since 1989 to improve the quality of plan audits.

We also identified ways to enhance plan reporting and audits and thus strengthen key ERISA safeguards.

To identify the requirements for plan audits, we reviewed requirements for audits contained in sections 103 and 104 of ERISA (29 U.S.C. 1023, 1024 (1988)) and Labor regulations (29 C.F.R. part 2520 (1990)). In addition, we reviewed various AICPA publications, including the AICPA Codification of Statements on Auditing Standards and the AICPA Audit and Accounting Guide for Employee Benefit Plans (1983 edition, 1990 exposure draft, and 1991 edition).

To identify problems in the performance of plan audits, we randomly selected 25 audits from among 50 of the 64 plan audits the IG reported as violating at least one auditing standard. We excluded from our selection the 14 plan audits that Labor had referred to the AICPA for review. However, we obtained information from the AICPA on the results of its review of these 14 plan audits and considered its findings in developing our recommendations.

The 25 plan audits selected for our detailed review examined assets of \$126 million held by 12 defined contribution pension plans, 8 defined benefit pension plans, and 5 health and welfare plans. A total of 21 audit firms performed these audits nationwide. These included 11 local firms having one office, 6 national firms, and 4 regional firms with multiple offices. Four of these 21 audit firms each performed two of the selected audits.

In evaluating these plan audits, we reviewed audit reports, audit programs, supporting working papers, and permanent files. We also used a standard data collection instrument to record our findings and discussed the audit work with appropriate staff at each of the 21 audit firms involved.

We measured the quality of these plan audits by the extent of their compliance with auditing standards and ERISA reporting and disclosure requirements that were in effect when they were performed. In so doing, we made professional judgments about the nature and significance of violations of auditing standards and ERISA reporting requirements and their effects on each audit as a whole. Then, we categorized the audits as satisfactory or unsatisfactory. In our judgment, a satisfactory audit complied with all pertinent auditing standards and ERISA requirements or included only technical violations that did not affect the quality of the audit as a whole. An unsatisfactory audit included auditing standards violations which were so severe that the reliability or usefulness of the audit report was seriously diminished.

To assess the reasonableness of the IG's findings, we reviewed the IG's November 1989 report entitled Changes Are Needed in the ERISA Audit Process to Increase Protections for Employee Benefit Plan Participants; its sampling methodology; and review guides that the IG used in evaluating plan audits. We also interviewed IG staff and reviewed the IG's working papers for each selected audit. Based on our own assessment of the auditor's work, we made professional judgments about the validity of auditing standards violations identified by the IG.

To evaluate actions taken since 1989 to improve the quality of plan audits, we obtained information on pertinent legislation proposed by Labor and on AICPA actions.

We conducted our work from April 1990 through August 1991 in accordance with generally accepted government auditing standards.

We obtained written comments on a draft of this report from the Department of Labor and the American Institute of Certified Public Accountants. Their comments are included in their entirety in appendixes II and III.

Deficiencies in Audits of Employee Benefit Plans

Nine of the 25 plan audits we reviewed had auditing standards violations that were so severe that the reliability or usefulness of the audit reports was seriously diminished. Many of the deficiencies we identified stemmed from lack of auditor knowledge about special considerations associated with auditing employee benefit plans. The November 1989 IG study and the AICPA investigation of 14 plan audits referred by Labor identified similar problems.

Although we concluded that the remaining 16 plan audits in our review generally complied with auditing standards, we found that most included standards violations of a technical nature, which, in our judgment, did not seriously diminish the reliability or usefulness of the audit report.

Insufficient Evidence of Audit Work

The working papers for eight of the nine plan audits having serious problems did not comply with auditing standards for fieldwork due to problems with planning, supervision, or retention of audit evidence in the form of working papers. Many of the specific deficiencies in these audits reflected special problems associated with auditing employee benefit plans.

Auditing standards for fieldwork generally encompass the planning and performance of audits as well as the sufficiency and competency of evidential matter obtained to support the auditor's conclusions and opinions. These standards also require auditors to retain a written record in the form of working papers. The information contained in working papers constitutes the principal record of an auditor's work and conclusions reached when performing an audit.

Insufficient Planning and Supervision

The fieldwork standard for planning and supervision requires that audit work be adequately planned and that staff, if any, be properly supervised. In planning an audit, auditors should prepare a written audit program or set of programs which set forth, in reasonable detail, the audit procedures necessary to accomplish the audit's objectives.

The working papers for eight of the nine plan audits having serious problems showed insufficient evidence of planning. The working papers in four cases lacked written audit programs, and the audit programs for another four cases omitted such elements as objectives, reporting requirements, or a description of planned auditing procedures for major audit segments. The omitted elements pertained to matters which auditors should consider when developing an overall strategy for conducting a plan

audit. For example, two of these audit programs for defined benefit pension plans omitted auditing procedures for testing the reliability of payroll, demographic, and benefit data for plan participants. This type of participant data is critical to actuarial valuations of contributions and accumulated plan benefits for defined benefit pension plans.

The fieldwork standard for planning and supervision also requires auditors to review the work performed by staff to determine whether it was adequately performed and to evaluate whether the results are consistent with the conclusions in the audit report. The working papers for six of the nine plan audits having serious problems showed insufficient evidence of supervision. Three cases showed no evidence of supervisory reviews, and evidence of such reviews was incomplete in another three cases.

During its investigations of the 14 plan audits referred by Labor, the AICPA found similar problems with planning. According to the AICPA, five of these plan audits lacked written audit programs and another three included audit programs which did not detail the auditing procedures necessary to accomplish the audit's objectives.

Inadequate Evidence of Testing

The fieldwork standard for evidential matter requires auditors to obtain sufficient competent evidential matter through inspection, observation, inquiries, and confirmations to afford a reasonable basis for expressing an opinion regarding the financial statements under examination. The working papers for eight of the nine plan audits having serious problems showed insufficient evidence that various audit segments had been performed. Many of these audit segments involved special considerations associated with auditing employee benefit plans' financial statements. Given this insufficient evidence, six of these eight plan audits included inadequately supported, unqualified opinions on the plans' financial statements.

Insufficient Evidence of Actuarial Valuation Tests

The reliability of actuarial valuations is critical in defined benefit pension plan audits because auditors use such valuations to substantiate actuarial computations of required contributions and accumulated plan benefits. Accumulated plan benefits are the present value of benefits due to participants in the future. The fieldwork standard for evidence precludes auditors from simply relying on actuarial reports for these amounts. Rather, auditors must ascertain that the actuary has the necessary professional qualifications and then assess the reasonableness of the actuary's objectives, methods, and assumptions. Further, auditors must

test the reliability and completeness of participant data used in making actuarial valuations. Testing the adequacy of payroll, demographic, and benefit data which are provided to actuaries is critical because actuaries use this data in making actuarial valuations of contributions and accumulated plan benefits. Significant errors in participant data provided to actuaries may have a material effect on the amounts of contributions required. For example, if these contributions are underestimated, plans will lack the assets needed to fund the benefits of plan participants.

In three cases, the working papers for audits of defined benefit pension plans showed little or no evidence that the work of actuaries or related participant data were tested. For example, in one case, the working papers contained no evidence supporting the appropriateness of the \$2.4 million in accumulated plan benefits shown on the plan's financial statements. The actuary's report included in the working papers for another case was dated after the date of the auditor's report. In addition, the working papers for one of these cases showed no evidence that the actuary's qualifications were assessed.

During its investigations of the 14 plan audits referred by Labor, the AICPA found that four did not include sufficient evidence of testing participant data.

Insufficient Evidence of Allocation Tests

According to the AICPA audit guide, auditors should test whether plan earnings and employer contributions were properly allocated to the accounts of plan participants in defined contribution pension plans. Such tests are important since these allocated amounts represent the accumulated benefits available for each plan participant.

We found that the working papers for three audits of defined contribution pension plans showed no evidence that allocations of contributions to participant accounts were tested. In one case, for example, no allocations of contributions for all 146 plan participants were tested.

In two of the three cases, the working papers for audits of defined contribution plans also contained insufficient evidence that required tests of material contributions or benefit payments had been performed. In one of these cases, the working papers contained no evidence that tests were made to confirm that employer contributions totaling about \$165,000 equaled the amount authorized. Further, the working papers showed no evidence that tests were done to ascertain if benefit payments of about \$88,000 made by the plan's trustee were received by individuals entitled to

them. Such tests are important to ensure that benefit payments were not made to deceased individuals or others not qualified under the provisions of a plan.

Insufficient Evidence of Insurance Premium Tests

According to the AICPA audit guide, auditors should determine if premium amounts sent to insurance companies by health and welfare plans that provide benefits through purchased insurance are appropriate. Premium amounts are generally determined from participant eligibility records and premium rates in insurance contracts.

In two cases, the working papers for audits of health and welfare plans showed no evidence that the responsible auditors obtained insurance contracts or confirmed premium payments to test the appropriateness of amounts paid. In one case, these payments amounted to about \$2.3 million of the plan's \$3.4 million total disbursements. This audit's working papers also showed no evidence that the auditor obtained insurance contracts or confirmed premium amounts to test about \$2.57 million in estimated liabilities for future benefits out of \$2.60 million in total plan liabilities. In the other case, these premium payments amounted to about \$4.6 million of the plan's \$4.7 million in total disbursements.

Insufficient Evidence of Discretionary Trust Tests

Plan investments are ordinarily administered separately from other plan operations because fiduciaries usually engage a trustee, investment advisor, or both to manage such investments. According to the AICPA audit guide, auditors should be aware that, in planning auditing procedures, they need to consider the nature of trustee arrangements as well as the physical location of and control over plan records and investments.

Discretionary trustee arrangements authorize trustees to purchase and sell investments within the framework of trust instruments. As a result, plan administrators often do not have their own records of transactions executed by these trustees and must rely on information provided by the trustee. According to the AICPA audit guide, auditors performing an audit involving a discretionary trust should obtain evidence about the adequacy of the trustees' internal control structure. To do so, the guide suggests that auditors obtain a special purpose report on a trustee's internal controls. This report, which is sometimes referred to as a single-audit report, is prepared by an auditor engaged by the discretionary trustee. If a single-audit report cannot be obtained, the AICPA audit guide suggests that the auditor evaluate the discretionary trustee's internal controls.

In two cases, discretionary trustees controlled investments which were material to plan financial statements. The working papers for both audits, however, showed no evidence that the responsible auditors obtained single-audit reports or evaluated discretionary trustees' internal controls. Yet in both cases, the auditors inappropriately expressed inadequately supported unqualified opinions. Investments controlled by these trustees amounted to virtually all of these plans' assets.

Insufficient Evidence of Testing Transactions Involving Parties in Interest

ERISA prohibits transactions involving conflicts of interest and requires disclosure of transactions with parties in interest. The fieldwork standard for evidence requires auditors to obtain representation letters from the audit client and the client's attorney. According to the AICPA audit guide, letters obtained from the client should cover undisclosed transactions involving parties in interest. Letters obtained from the client's attorney also may include statements regarding such transactions and should describe and evaluate pending or threatened litigation, claims, and assessments involving the attorney. The AICPA audit guide suggests other auditing procedures to identify prohibited transactions. For example, the guide suggests that the auditor obtain a list of parties in interest to help determine if transactions involving them have occurred.

In three cases, the working papers for plan audits did not contain client representation letters, and, in two of these cases, the working papers also did not contain representation letters from the clients' attorneys. In addition, the three cases' working papers showed little or no evidence that auditing procedures suggested by the AICPA audit guide were performed to identify transactions involving parties in interest.

During its investigations of the 14 plan audits referred by Labor, the AICPA found that five failed to obtain (1) sufficient evidence of testing for party-in-interest transactions and (2) representation letters from the client, the client's attorney, or both.

Inadequate Reporting

The audit reports for five of the nine plan audits having serious problems did not comply with the auditing standards for reporting because these reports did not address inadequate financial statement disclosures. Auditing standards for reporting require auditors to take exception to financial statements that do not adequately disclose material matters. These matters relate to the form, arrangement, and content of the financial statements and their footnotes. If the financial statements omit such disclosures, including required footnotes, an auditor should express a

qualified or adverse opinion and describe the omitted matters in the audit report.

In four cases, we found that auditors expressed unqualified opinions on plan financial statements that did not disclose material matters, and the audit reports for these cases did not describe the material matters omitted. In one case, the plan financial statements were materially misstated because they omitted all information about one of the plan's two trusts. The net assets of the omitted trust amounted to about \$510,000, or 13 percent, of the plan's total net assets. In two other cases, the financial statements of defined benefit pension plans did not disclose accumulated plan benefits. The AICPA audit guide specifically cites this type of omission as cause for a qualified or adverse opinion. The fourth case had a number of problems including financial statements that did not disclose the year-to-year changes in the actuarial present value of accumulated plan benefits.

In the fifth case, involving a disclaimer of opinion, a plan reported information on a Form 5500 on its net assets and changes in net assets available for plan benefits but did not provide all the footnotes required by ERISA. Instead of reporting this fact as required by Labor regulations, the audit firm's report stated that the information presented on the Form 5500 complied with Labor rules and regulations. This statement was incorrect.

During its investigations of the 14 plan audits referred by Labor, the AICPA found that five of these audit reports failed to identify and describe omitted footnotes or material matters.

Problems Identified by the IG Were Generally Valid

Overall, we believe that the IG study's criticisms of plan audits for violating auditing standards were reasonable. Generally, our review of 25 plan audits identified problems similar to those identified by the IG in its November 1989 study. The IG study reported problems such as a lack of audit programs, insufficient testing or documentation, and problems with opinions on ERISA schedules.

In reviewing the IG's work, we also noted that the IG selected its 279 sample plan audits from less than half of the approximately 55,000 plans with 100 or more participants subject to the audit requirement that filed 1986 annual reports. According to IG representatives, selecting a timely sample from all of the plans filing for 1986 would have been difficult because of late filings. They explained that delaying their selection to

include most late filers would have resulted in their sampling plan audits that were 3 years old.

We did not always concur with the IG's criticisms of individual plan audits. In five of the 25 audits we reviewed, we did not agree with any of the specific violations identified by the IG. However, in all five of these cases, we found other auditing standards violations not identified by the IG study. These disagreements generally reflected differing professional judgments about sufficiency of evidence, reporting, due professional care (which requires that an auditor be conscientious in the conduct of the engagement), or a combination of these factors.

AICPA Investigations Upheld Most of Labor's Findings

The AICPA, as the national professional association of over 300,000 certified public accountants, plays a key role in assuring the quality of audits. Although the AICPA can bring CPAs before its trial board and recommend expulsion from its membership, its enforcement process usually emphasizes remedial actions.

The AICPA Professional Ethics Division independently investigated all 14 plan audits referred by Labor. It found various problems in 10 of the 14 plan audits which, as discussed earlier, included lack of audit programs, insufficient evidence, and inappropriate opinions. Following its investigations, the Professional Ethics Division took varying disciplinary actions against the auditors who conducted the 10 problem audits. The other four were closed with a finding of no violation.

Auditors Lacked Required Knowledge

Based on discussions with auditors and reviews of their working papers, we concluded that many of the problems with plan audits reflected a lack of knowledge by auditors about specialized procedures needed for auditing employee benefit plans. Table 2.1 summarizes problems that we identified that are associated with special auditing procedures and considerations for plan audits.

**Table 2.1: Auditing Standards Violations
Related to Special Procedures or
Considerations for Plan Audits**

Auditing standards violation	Special procedure or consideration
Insufficient evidence	Tests of participant data
	Tests of actuaries' work
	Tests of allocations of employer contributions to participant accounts
	Tests of insurance premium amounts
Inappropriate unqualified opinion	Reviews of single-audit reports or tests of internal controls for discretionary trustees
	Consideration of the adequacy of financial statement disclosures about accumulated plan benefits

The responses of individual auditors we talked with illustrate this lack of industry knowledge. When asked why participant data were not tested for a defined benefit pension plan, one auditor did not know what the applicable participant data elements were. Another auditor responded that he obtained the source and support for about \$2.4 million in accumulated plan benefits over the telephone from the plan's actuary. As previously discussed, auditing standards preclude auditors from simply accepting actuaries' calculations at face value. Instead, auditors should obtain evidence of actuaries' methods, assumptions, and participant data as well as their professional qualifications. Further, auditors should obtain a copy of the actuarial report. This additional evidence allows auditors to evaluate the reasonableness of the actuary's work.

Auditors Lacked Awareness of ERISA Reporting and Disclosure Requirements

We also found that auditors' awareness of ERISA reporting and disclosure requirements was often limited. In addition to specifying detailed reporting requirements, ERISA authorizes the Secretary of Labor to prescribe simplified and alternative methods of compliance as the Secretary determines appropriate. By regulation, the Secretary has prescribed such methods. Therefore, in preparing the annual ERISA report, plan administrators may follow the requirements delineated by ERISA (statutory method) or by Labor regulations (regulatory method). Auditors performing 10 of the 25 plan audits in our review said they did not know whether the financial statements they examined followed the statutory or regulatory method of reporting. Such knowledge is essential because these two methods have different requirements for reporting elements, such as the accounting principles used to prepare financial statements, financial

statement footnotes, and ERISA schedules. Appendix I provides details on the statutory and regulatory methods of reporting.

Financial statements for 7 of the 25 plan audits did not include all required footnotes, and 18 omitted ERISA schedules. In seven cases, the auditors performing these plan audits said they were unaware of the requirements for the omitted ERISA schedules. In two other cases, the auditors offered interpretations of exemption provisions as the reason for omitting the required schedules. In both cases, the auditors misinterpreted the regulations. For example, these auditors inappropriately excluded from the schedule of reportable transactions all transactions involving debt obligations of the United States. Such transactions are exempt from the schedule of reportable transactions only in some instances.

The IG study and the AICPA's review of this study also found that auditors lacked a full understanding of ERISA reporting and disclosure requirements. One finding in the IG study was that 181 of the 279 plan audit reports reviewed did not disclose that the financial statements or schedules lacked at least one ERISA-required disclosure. For example, the IG study cited 84 of the 181 plans that did not comply with the requirement to include a schedule of assets held for investment. In analyzing the findings and recommendations presented in the IG study, the AICPA staff identified two primary causes for plan audit problems: auditors' lack of understanding of ERISA requirements for plan audits and their failure to follow guidance in the AICPA audit guide.

Conclusions

Overall, the IG's criticism of employee benefit plan audits was reasonable. Our review and the investigation by the AICPA of cases referred to its Professional Ethics Division found many problems similar to those reported by the IG. Nine of the audits in our review contained standards violations that were so severe that the reliability and usefulness of audit reports was seriously diminished. In addition, failures by auditors to comply with auditing standards raise questions about the credibility of plan financial information reported to plan participants and regulators. Credible financial information is essential to protect the interests of plan participants and the government as an insurer of some plans.

Our findings and those of the AICPA also paralleled the IG's findings regarding auditors' lack of knowledge. Our review showed that some auditors were not fully aware of ERISA's reporting and disclosure

requirements. The IG and the AICPA reached similar conclusions regarding the causes for inadequacies in plan audits.

Recommendations

Because of the severity of the violations identified in nine audits, we recommend that the Department of Labor reconsider the nine audits and refer the auditors to professional and/or licensing authorities if deemed appropriate.

Agency Comments and Our Response

Comments From the Department of Labor

In commenting on a draft of this report, officials from the Department of Labor proposed an alternative approach to our recommendation on referral of the nine audits with severe violations. Because of the age of the audits and the current backlog of referrals, Labor proposed reviewing more recent audit reports prepared by the firms in question. We agree with Labor's plan to look at more recent work. However, in looking at more recent work, we believe that Labor should review supporting working papers as well as audit reports.

Comments From the AICPA

The AICPA stated that it takes allegations concerning poor performance by independent accountants extremely seriously and agreed to review and investigate the nine audits if Labor determines that such action would be cost-effective.

The AICPA also stated that audit deficiencies, if and when they occur, do not necessarily correlate with plan mismanagement or beneficiary risk. It stated that the risk is overwhelmingly influenced by factors beyond the scope of audits of financial statements or the influence of independent accountants. The most prominent of these factors is the quality of investment judgments by plan administrators or investment fiduciaries.

We agree that the quality of investment judgments is a major risk affecting plans. However, credible information about these investment judgments and the internal controls over them is critical in assessing how well plan administrators and investment advisors have exercised their fiduciary responsibilities. Audit deficiencies involving incomplete disclosure of plan

investments or inadequate testing of investments can seriously diminish the usefulness and credibility of investment information available to plan participants and regulators. Consequently, we believe that audit failures can significantly increase risk to plan participants.

AICPA Initiatives to Improve Audit Quality

In response to the November 1989 IG study, the AICPA acted to improve the quality of future audits. For example, it has publicized problems with the performance of employee benefit plan audits and has expanded audit guidance on how to conduct these audits. While these initiatives are helpful in educating the audit community, we identified additional actions that the AICPA could take to address the deficiencies identified in our review and further strengthen the guidance provided to auditors.

Publicizing Problems With Performing Plan Audits

To address audit firms' lack of understanding of ERISA requirements, the AICPA widely publicized the IG study's results and findings. Various AICPA publications reported on the IG's criticisms of audits, including The CPA Letter and the April 1990 Journal of Accountancy, which featured a seven-page article discussing the IG's study. The CPA Letter is a news report published for the AICPA membership. The monthly Journal of Accountancy, with a circulation of over 300,000 to AICPA members and other subscribers, includes information on such topics as accounting, auditing, tax, and legal issues.

The AICPA made its membership aware of the results of the IG study. Under AICPA policy, however, the results of its investigations of the 14 plan audits mentioned earlier will not be published unless the results are presented to the AICPA trial board and the trial board finds one or more members guilty of violating the Code of Professional Conduct. The AICPA Professional Ethics Division referred 3 of these 14 plan audits to the trial board. Of the three cases, one trial board hearing has been held and the auditor was found guilty. A second case was scheduled to be heard in January 1992. The third referral was contingent on whether the auditor continued to practice. That auditor has elected to retire and surrender his CPA license.

According to AICPA representatives, it considers its investigations of individual audit firms highly sensitive, and the results are confidentially provided only to those investigated. As a result, other members are not routinely apprised of the AICPA's findings regarding specific audit deficiencies or of related disciplinary actions.

Expanding Guidance on Conducting Plan Audits

The AICPA has issued a number of publications to improve the quality of future plan audits, including audit risk alerts and a specialized checklist. It also sponsored a national training conference.

Most importantly, the AICPA revised its guide for auditing employee benefit plans in March 1991 to include the many changes in auditing and accounting standards that had occurred since 1983, when the guide was originally published. For example, new auditing standards require that audit firms design their audits to provide reasonable assurance of detecting material errors, irregularities, and illegal acts and that they communicate irregularities, illegal acts, and significant control weaknesses to their clients.

In addition, the revised audit guide expanded information on statutory provisions and regulations applicable to audits of employee benefit plans. For example, the revised guide includes a five-page chapter devoted exclusively to party-in-interest transactions that the 1983 guide covered in less than one page. The revised chapter expands both explanatory information about party-in-interest transactions and suggests auditing procedures for identifying these transactions. However, as discussed in chapter 4, problems with the basic accounting and auditing standards for related party transactions exist. The industry guide cannot deal with these problems until the basic standards are improved.

Further, the revised guide includes a 33-page appendix describing ERISA and related regulations. According to the AICPA, this appendix, which was prepared with Labor's assistance, will make it easier for audit firms to familiarize themselves with important ERISA provisions. The AICPA is currently publishing audit guides in loose-leaf form, which should facilitate prompt updates on relevant emerging issues.

The AICPA informs audit firms of important developments related to ERISA and AICPA requirements through periodic updates to the AICPA audit guide. In 1990 and 1991, the AICPA published Employee Benefit Plans Industry Developments to give audit firms an overview of matters that may affect plan audits, including recent economic, professional, and regulatory developments. These publications also incorporated audit risk alerts which, based on current information and trends, describe factors that may be especially significant in plan audits. For example, failing to disclose known violations of ERISA regulations in audit reports was among the highlighted risks. The alerts are for firms to use in planning their audits.

To further assist auditors in auditing defined benefit pension plans, the AICPA published its Checklist for Defined Benefit Pension Plans and Illustrative Financial Statements in April 1990. This checklist provides a number of brief questions or statements which serve as memory aids for preparing financial statements and audit reports. The checklist covers financial statements, financial statement footnotes, ERISA reporting requirements, and audit reports. Further, it provides illustrative audit reports and financial statements for defined benefit pension plans.

In December 1990, the AICPA sponsored a national training conference, with Labor's participation, on auditing employee benefit plans. The conference focused on (1) current issues affecting plans and plan audits, (2) various ERISA requirements, and (3) the IG's criticisms of plan audits. Another such conference was held in December 1991.

We recognize that the AICPA has taken important steps to monitor developments in the environment in which plans operate and to provide audit guidance more promptly. We consider the AICPA decisions to issue the revised audit guide quickly and to publish audit guides in loose-leaf form to be responsive steps which can improve the quality of plan audits.

However, a number of problems identified in our review of plan audits are not adequately dealt with in the revised audit guide. They include the following:

- Although audit firms are engaged by plan administrators to perform plan audits on behalf of all plan participants, the guide does not discuss the importance of audits in protecting plan participants. Since these audits are a key safeguard for protecting the assets which underwrite the benefits of plan participants, we believe that it is critical that audit firms keep the protection of plan participants in mind when auditing these plans.
- The revised guide does not discuss the importance of industry knowledge in auditing employee benefit plans.
- The revised guide does not clearly explain the requirements for schedules, financial statement footnotes, and related generally accepted accounting principles (GAAP) requirements.

Conclusions

In response to the IG's criticisms of audits, the AICPA promptly initiated appropriate steps to improve future audits. These included revising its audit guide, publicizing the results of the IG study, and alerting audit firms to the requirements of ERISA.

Still, a number of the specific problems identified in our review are not adequately addressed in the revised guide. Greater clarification of audit requirements would improve audits and, thus, further protect the interests of plan participants and the government. Reporting the AICPA's investigation results to its membership would increase the profession's awareness of the consequences of poor auditing and the problems that should be avoided in plan audits. We believe that communicating the details of problems with these audits without identifying specific firms will maintain the confidential nature of these investigations while fostering an increased awareness of the types of problems that must be avoided.

Recommendations

To further strengthen audits of employee benefit plans, we recommend that the AICPA change its audit guide to

- discuss the importance of audits in protecting plan participants;
- discuss the need for auditors to have specialized industry knowledge needed to successfully perform plan audits; and
- identify and clearly describe requirements for specific schedules and financial statement footnotes. These requirements should include those for statements prepared under the statutory and regulatory methods, as well as GAAP requirements.

We also recommend that the AICPA communicate to its membership the results of (1) its investigations of the 10 audits referred by Labor, with which the AICPA found problems and (2) future investigations of deficient plan audits.

Agency Comments and Our Response

Comments From the Department of Labor

In commenting on our recommendation to the AICPA that it make changes to the audit guide, Labor stated that it believes the guide already contains the necessary basic guidance for auditing. We continue to believe that improvements should be made to the audit guide to add information about the importance of audits in protecting plan participants and to discuss the need for auditors to have specialized industry knowledge. We also continue to believe that information on required schedules and footnotes should be clarified.

Labor agreed with our recommendation on communicating results of investigations and stated that Labor has urged the AICPA to publicize the results of its investigation of employee benefit plan audits referred by Labor.

Comments From the AICPA

The AICPA responded that, in its audit guide, it will expand information on the importance of audits in protecting plan participants. It also will consider expanding the audit guide to (1) discuss the need for specialized industry knowledge to audit plans successfully and (2) identify and clearly describe schedule and footnote requirements.

The AICPA agreed to consider publishing the results of future investigations of plan audits by the AICPA Professional Ethics Division. The AICPA pointed out that the nature and extent of its ethics investigations were discussed at its Employee Benefit Plans Conference in December 1991 and that this information will also be covered in a future article in the Journal of Accountancy, the AICPA's monthly publication.

Strengthened Requirements Would Better Protect Plan Participants

Employee benefit plan administrators are responsible for establishing sound internal controls and for complying with ERISA and related Labor regulations. However, neither plan administrators nor plan auditors are required to report on internal controls, including those established to ensure compliance with laws and regulations. Also, ERISA allows plan administrators to exclude from the scope of the plan audit (limited scope audit) plan assets held by certain regulated institutions, such as banks and insurance companies. As a result, the limited scope plan audits we reviewed provided little or no assurance about the existence, ownership, or value of plan investments involving millions of dollars. The significance of the assets may result in auditors' issuing disclaimers of opinion, which may confuse financial statement users. We believe that removing ERISA's limited scope provision and expanding current ERISA requirements to address the internal control issue and other conditions could substantially improve plan management and enhance the usefulness and reliability of plan audits. In addition, the broader issues affecting accounting and auditing standards and accountability that we have recommended in past reports are relevant to employee benefit plans.

ERISA's Limited Scope Provision Diminishes Value of Audits

Currently, ERISA allows plan administrators to exclude plan investments held by certain regulated institutions, such as banks and insurance companies, from the scope of a plan audit. Because these assets may be a significant segment of plan assets, this type of scope limitation may result in auditors disclaiming an opinion on the plan's financial statements. This diminishes the value of the audit and may confuse statement users. Also, there is no reason to believe that these assets are not vulnerable and do not need audit.

Ten plan audits in our review were limited scope audits and thus did not include examination of any of their combined \$34 million in total plan assets. The \$34 million in plan assets not examined represented over a quarter of the \$126 million in plan assets held by all 25 plans we reviewed.

Auditing plan assets, which secure the benefits for plan participants, is an essential auditor responsibility. In spite of the importance of this responsibility, auditors may largely ignore it when performing a limited scope plan audit, which typically provides only minimal assurances about the existence, ownership, and value of a plan's assets held in trust. In a full scope audit, the plan auditor must gain sufficient support for transactions executed by the trustee. If the trustee has engaged an independent auditor to prepare a special purpose report on the trust department's internal

controls (sometimes referred to as a single auditor report), the plan auditor should obtain and read a copy of the latest available report for use in determining the scope of his or her audit procedures, if any. Ordinarily it should not be necessary for the plan auditor to review the trust department auditor's single-audit working papers, provided the plan auditor is satisfied with the professional reputation and independence of the trust department auditor.

Limited Scope Audits Cause Confusion Among Report Users

If the audit's scope is not sufficient to allow the auditor to form an opinion, auditing standards require auditors to express a disclaimer of opinion, which states that the auditor does not express an opinion on the financial statements. The AICPA's suggested language for a disclaimer of opinion resulting from ERISA's limited scope provision follows:

"Because of the significance of the information that we did not audit, we are unable to, and do not, express an opinion on the accompanying financial statements and schedules taken as a whole. The form and content of the information included in the financial statements and schedules, other than that derived from the information certified by the trustee, have been examined by us and, in our opinion, are presented in compliance with the Department of Labor Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974."

We believe that audit report users can interpret this suggested language in two ways. On one hand, the opinion initially suggests that no assurance can be provided regarding financial statement amounts not excluded under the ERISA limited scope provision when it says ". . . we are unable to, and do not, express an opinion on the accompanying financial statements and schedules taken as a whole" On the other hand, the opinion subsequently suggests that some assurance is being provided for the financial statement amounts when it says that the form and content of information included in statements and schedules ". . . in our opinion, are presented in compliance with the Department of Labor Rules and Regulations" As a result of these confusing statements, users of limited scope audit reports are likely to be uncertain about what, if any, assurance these reports provide.

Audit standards require auditors who perform these limited scope audits to complete all other audit procedures normally done on a full scope audit except those related to the excluded assets. In our review, we found that auditors generally performed sufficient work to support their opinions that

plan financial statements were presented in compliance with Labor rules and regulations. However, the IG study reported that some auditors in the study sample performed very little audit work in any area of plan operations when they knew they would issue a disclaimer of opinion because of ERISA's limited scope provision. The IG study cited one case where the auditor did not test contributions, benefit payments, or other areas because he planned to issue a disclaimer of opinion. According to the IG study, this auditor said that he believed the lack of testing had no further effect on his disclaimer of opinion.

Actions to Require Full Scope Audits

We believe that a disclaimer of opinion as a result of the ERISA limited scope provision severely limits the usefulness of a plan audit to regulators, plan participants, and others. According to the AICPA, plan participants cannot be provided the full assurance intended by ERISA if the audit excludes certain assets. The November 1989 IG study advocates eliminating ERISA's limited scope provision for the same reasons.

A Senate bill (S. 269, 102nd Cong.) introduced in January 1991 proposes eliminating the ERISA limited scope provision. The bill's sponsors have stated that without thorough and comprehensive audits, the assurances intended by ERISA for pension beneficiaries will not be achieved. The sponsors have further stated that taxpayers have an interest in maintaining tight regulation and requiring full disclosure for industries and enterprises covered by federal pension insurance.

Reporting on Internal Controls Would Enhance Audit Usefulness

Internal controls are the policies and procedures established by management to provide reasonable assurance that specific plan objectives will be achieved. Internal control objectives include assuring reliability of financial records, compliance with laws and regulations, and safeguarding assets. Currently, neither ERISA nor its implementing regulations require either plan administrators or auditors to report on the effectiveness of a plan's internal controls.

We believe that annual reporting on internal controls by plan administrators, subject to auditor review and attestation, would be appropriate and useful. Plan administrators have a fiduciary responsibility to operate plans in the best interest of plan participants. Requiring plan administrators to prepare and sign reports on the effectiveness of the internal control structure, including controls for compliance with laws and regulations, and then providing the reports to regulators, participants, and

others would help ensure that adequate controls are maintained. Requiring auditors to review and report on plan administrators' reports on internal controls would help protect the plan participants' interests by helping to ensure that plans maintain strong internal controls, adhere to laws and regulations, and properly report their financial condition. Such reviews could also provide early warnings of potential problems. Similarly, reviews of internal control reports would benefit the federal government, which, as insurer of defined benefit pension plans, faces a significant liability if plans with large unfunded liabilities terminate.

Further, we also believe that auditors have a basic responsibility to protect the interests of participants and the government when auditing federally insured employee benefit plans. Auditors should take an active role in assisting regulators and plan administrators in identifying, preventing, and correcting problems in financial reporting and internal controls. This expansion of the auditor's role is in keeping with our belief that audit firms should assume greater responsibility when accepting audit engagements for federally insured entities. We have also taken this position on audits of other federally insured entities, such as savings and loan institutions and banks.

We have previously recommended¹ that reports on internal controls (1) describe management's responsibility and actions taken by it for establishing and maintaining an effective internal control structure and for preparing financial statements, (2) contain management's assessment of the effectiveness of the internal control structure, (3) report material weaknesses that have not been corrected, and (4) contain the signature of the appropriate officer. We believe that reporting such information with respect to employee benefit plans subject to ERISA would also be appropriate. Congress recently included similar requirements for federally insured financial institutions in the Federal Deposit Insurance Corporation Improvement Act of 1991 (Public Law 102-242).

ERISA Violations Not Directly Reported to Labor

While both plan participants and Labor have significant interests in ERISA violations, there is no requirement in ERISA or Labor's implementing regulations that either be promptly and directly informed by the auditor when fraud or serious fiduciary breaches are discovered. Rather, plan administrators are required to report certain violations, such as prohibited party-in-interest transactions, through the annual reporting process.

¹Failed Banks: Accounting and Auditing Reforms Urgently Needed (GAO/AFMD-91-43, April 22, 1991).

The IG study took the position that there is a basic flaw in any system which asks individuals to report their own violations. We agree. The study also discussed significant problems with Labor's procedures for reviewing plan annual reports. First, the sheer volume of annual reports prevents enforcement staff from reviewing each report for ERISA violations. Second, the IG study explained that plan annual reports normally take about 2 years to reach enforcement staff. The study attributed this to (1) Labor regulations which allow 210 days from the end of a plan's fiscal year to file annual reports and (2) the time needed to process these reports at IRS and Labor. As a result, the IG study concluded that even if audit reports disclose violations, there are no assurances that those disclosures would come to Labor's attention promptly.

Like ERISA, auditing standards do not require that auditors report serious ERISA violations directly to Labor, even when they are not reported by a plan administrator. These standards do, however, require auditors to report errors, irregularities, and illegal acts detected during an audit. They are to be reported to a party that is above the level of the party involved in the illegal activity, such as an audit committee or board of trustees. In the case of employee benefit plans, for a single employee plan that does not have an audit committee, the party with the level of authority and responsibility equivalent to an audit committee would normally be the named fiduciary. The named fiduciary is often the plan sponsor, an officer thereof, or the sponsor's board of directors. For a multiemployer plan, authority and responsibility equivalent to that of an audit committee would ordinarily rest with the board of trustees.

Further, auditing standards require an auditor to express a qualified opinion, adverse opinion, or disclaimer of opinion, depending on the circumstances, if an error, irregularity, or illegal act has a material effect on the financial statements. Also, in cases involving illegal acts, even those that are immaterial, the auditor may conclude that if the client does not take the remedial action considered necessary, the auditor should withdraw from the engagement. Although Labor instituted a requirement in filing year 1988 to report termination of accountants (Schedule C to the Form 5500), including a description of any disagreement, this new report is triggered only if the auditor is terminated.

Traditionally, auditing standards have recognized the existence of a special auditor-client relationship, with the auditor's primary responsibility being to the client. Accordingly, any outside reporting has generally been

considered the client's responsibility. In the context of plan audits, however, viewpoints differ on auditor-client relationships.

Current auditing literature does not require auditors to directly report to Labor because such reporting should be performed by plan administrators. This viewpoint generally reflects the traditional view that plan administrators are the clients.

However, the IG study points out that plan participants have significant interests in ERISA violations and plan participants are actually the client because ERISA specifies that auditors perform audits for them. The IG study further expresses the view that plan participants or a party acting as their agent should be informed of ERISA violations. The study explained that Labor is fully empowered by the Congress to act on behalf of plan participants and should receive information that identifies potential threats to plan participant benefits.

Peer Review Valuable in Assuring Audit Quality

Currently, neither ERISA nor its implementing regulations requires audit firms to participate in peer review programs. Peer review programs essentially entail the verification by other audit firms that the firm reviewed has a system of quality controls that reasonably ensures that audits meet established standards. Audit firms performing 12 of the 25 plan audits in our review had not participated in a peer review program. Further, seven of the nine audit firms performing the audits that did not satisfactorily comply with auditing standards had not participated in a peer review program. Similarly, the AICPA's analysis of the IG study findings indicated that audit firms which had been subject to a peer review had significantly fewer auditing standards deficiencies than audit firms which had not received a peer review.

Various AICPA committees set standards for the conduct of peer reviews by audit firms, associations, and state societies. One of two methods, systems oriented or engagement oriented, is used to evaluate the quality of an audit firm's work. Generally, large audit firms with more than 20 professional staff are subject to systems-oriented reviews that incorporate detailed tests of a firm's quality control system and a review of selected individual audits. Engagement-oriented reviews which stress testing and evaluation of individual audits are an option for smaller firms with fewer than 20 professional employees.

AICPA standards require that the engagements selected for review provide a reasonable cross section of the reviewed firm's accounting and auditing practice and that greater weight be given to audit engagements with high risk and significant public interest. In this regard, the AICPA recently issued guidance on one peer review program advising reviewers to give greater weight to plan audits when sampling audits for review. For two other peer review programs, the AICPA already requires the examination of at least one plan audit as part of each peer review. These actions should increase the likelihood of plan audits being included in peer reviews and, thereby, improve the quality of these audits in the future.

As part of the peer review process, a reviewer issues an opinion on the audit firm's compliance with AICPA quality control standards. The reviewer's findings, comments, and recommendations, and any AICPA information on sanctions imposed are generally available to the public. AICPA sanctions usually consist of required revisits by peer reviewers and submission of continued professional education records over a given period.

Currently, participation in a peer review program is mandatory for AICPA members in public practice. However, not all audit firms performing plan audits are AICPA members, and thus not all audit firms are required to participate in such programs.

A Senate bill (S. 3267, 101st Cong.) introduced in October 1990, would have amended ERISA to require peer reviews for all audit firms performing plan audits. Labor suggested that this requirement would serve the interests of participants, beneficiaries, and the government. Although the legislation was not enacted before the end of the Congress, we believe requiring audit firms to obtain a peer review which includes review of at least one plan audit would strengthen the peer review process as a control over the quality of plan audits. Labor has initiated another legislative package currently being considered by the administration and is considering this and other areas as a part of that proposed legislation.

Audit Reports Not Addressed to Plan Participants

Currently, neither ERISA nor its implementing regulations require that plan audit reports be addressed to participants even though auditors are engaged on their behalf. Of the 25 plan audit reports in our review, for example, only two were addressed to plan participants. We believe that audit reports addressed jointly to plan administrators and plan participants will more closely reflect the underlying nature of these engagements and

the accountability auditors have to both parties. Including plan participants as audit report addressees can also heighten auditors' awareness of their integral role in protecting plan participants' interests. This would parallel the current practices of Securities and Exchange Commission registrants' auditors, who generally address audit reports to both the shareholders and the board of directors.

Strengthened Requirements Consistent With Reforms in Other Areas

Many of the reforms discussed in this chapter are similar to reforms enacted or proposed for other industries and areas. For example, recent legislation² adopted many of our recommendations to require reforms to deal with inadequacies in financial statement audits of insured depository institutions, thereby helping to protect the government in its capacity as insurer of deposits in such institutions. Similar reforms for employee benefit plans would bring about increased protections for plan participants.

In the future, we will continue to evaluate such reforms, not only those recently enacted for insured depository institutions, but those enacted or proposed for employee benefit plans, federal departments and agencies, state and local governments, the insurance industry, and securities registrants. Recently we recommended³ that applicable accounting rules and auditing standards be revised to ensure that related party transactions are accounted for based on economic substance when the substance of transactions is materially different from the legal form. Also, we stressed the need for the Congress to legislate a core set of requirements to strengthen the present rules concerning internal controls for all public companies registered with the Securities and Exchange Commission, including requirements to increase reporting on internal controls by management and auditors, and direct reporting by auditors of irregularities.

²The Federal Deposit Insurance Corporation Improvement Act of 1991 (Public Law 102-242).

³Failed Banks: Accounting and Auditing Reforms Urgently Needed (GAO/AFMD-91-43, April 22, 1991).

Conclusions

Expanding ERISA's audit requirements will enhance the reliability of future plan audits and thus their usefulness in protecting the interests of plan participants and the government.

Limited scope audits currently allowed under ERISA provide inadequate assurance that plan assets are being safeguarded when auditors disclaim opinions on plan financial statements because these assets are material. There is no reason to believe that those excluded assets are not vulnerable and do not need audit. Also, disclaimers of opinion cause confusion as to the extent of assurance for other financial statement amounts. We believe that a disclaimer of opinion limits the usefulness of audits for plan participants, plan administrators, regulators, and others.

A plan administrator's report on the effectiveness of plan internal controls along with an auditor's assessment of the plan administrator's assertions would provide some assurance to plan participants that the plan is maintaining an effective control system. In addition, the report would emphasize plan administrators' responsibility for safeguarding plan assets and complying with laws and regulations.

We also believe the interests of plan participants and the government would be better served by auditors promptly reporting serious ERISA violations directly to Labor if plan administrators fail to do so. This would require reporting such violations significantly sooner than under the current annual reporting process. While there is no current requirement for auditors to report such matters directly to regulators, we agree with the IG study that Labor and plan participants have significant interests in ERISA violations.

Peer review is the cornerstone of the accounting profession's quality assurance efforts. However, not all audit firms participate in peer review, and those that do participate may not have a plan audit included in the audits reviewed. Requiring all audit firms which audit employee benefits plans to participate in a peer review program that includes at least one plan audit would help ensure that audit firms performing plan audits adhere to auditing standards and perform quality audits.

Auditors currently are not required to address audit reports to plan participants even though they are engaged to perform plan audits to protect plan participants. We believe that addressing audit reports to both plan administrators and plan participants will increase the auditors' awareness about their role in protecting plan participants.

Recommendations

We recommend that the Congress amend ERISA to eliminate the provision that permits plan administrators to direct audit firms to perform limited scope audits.

We also recommend that the Congress amend ERISA to require plan administrators to report on the effectiveness of plan internal controls and auditors to report on plan administrators' assessments of these controls. Reports prepared by plan administrators should be included in plan annual reports submitted to Labor and should

- describe actions taken to establish and maintain an effective system of internal control,
- contain the plan administrator's assessment of the effectiveness of the plan's internal control structure,
- identify material control weaknesses that have not been corrected, and
- contain the signature of the plan administrator.

We further recommend that the Congress amend ERISA to require that plan auditors

- report fraud and serious ERISA violations to Labor promptly after discovery if plan administrators do not do so,
- participate in a peer review program which assesses the quality of at least one plan audit, and
- address their reports jointly to plan administrators and participants.

Agency Comments and Our Response

Both the Secretary of Labor and the Chairman of the Board of the American Institute of Certified Public Accountants commented on a draft of this report. Their comments are included in their entirety in appendixes II and III of this report.

Labor agreed with many of our recommendations but expressed concerns with the recommendations on internal control reporting and direct reporting.

The AICPA stated that it is considering many of our recommendations. It also stated that it supports cost beneficial efforts and suggestions to increase the protection of plan participants but is concerned about creating unrealistic expectations about the role and work of independent accountants. We believe that implementing our recommendations would allow the profession to better meet the public's existing expectations.

Comments From the
Department of Labor

In commenting on a draft of this report, Labor agreed with our recommendation to eliminate the limited scope exemption for plan audits and said that Labor has a legislative package currently under consideration by the administration. The package would repeal this provision of ERISA. Labor stated its opinion that, under current law, it does not have authority to implement our recommendations on internal controls, direct reporting by auditors, and peer review. We continue to believe that Labor has the necessary authority to implement our recommendations but in view of Labor's response, we have modified our report to recommend that the Congress amend ERISA to require these improvements.

Labor agreed that significant internal control weaknesses can lead to fraud and abuse of plan assets. However, Labor expressed concern that a separate report on internal controls would be costly and may inundate Labor with thousands of reports which do not contain information on significant internal control weaknesses. Labor also stated that it is assessing alternative approaches for identifying and reporting significant internal control weaknesses.

We continue to believe that plan administrators' and auditors' reports on internal controls would be useful to plan participants and would emphasize plan administrators' responsibility for safeguarding plan assets and complying with laws and regulations. We believe a requirement for ERISA plans like that recently legislated for federally insured financial institutions would provide needed assurance to plan participants that the plan is maintaining an effective control system. Also, audit standards currently provide guidance on how to determine and report material internal control weaknesses.

Labor disagreed with our recommendation that auditors be required to report fraud and serious ERISA violations directly to Labor. Labor suggested that such a requirement may result in accountants making determinations outside of their area of expertise. We continue to believe that direct reporting is feasible and that auditors have the expertise to assess such violations. We believe that direct reporting would provide Labor with useful information for targeting its investigative efforts. Auditing standards currently provide guidance to auditors for considering potential illegal acts, including seeking the advice of legal counsel. Further, auditors are now required to make similar judgments about compliance with laws and regulations when auditing federal agencies and federal assistance provided to state and local governments and nonprofit organizations.

Labor also stated that it is considering whether plan administrators should be required to report to the Secretary of Labor information on certain criminal acts. Labor was also concerned that the wider range of direct reporting that we recommended would require shifting resources from reviews of plan filings and investigative casework. We believe that realigning Labor resources from routine review of plan filings to reported cases of serious violations would better target Labor's limited resources.

Labor agreed with requiring plan auditors to undergo peer review and pointed out that such a requirement is being considered as part of its current legislative package.

Labor also agreed with our recommendation to address audit reports jointly to plan administrators and participants, and said it plans to explore implementation of the recommendation through changes to its regulatory requirements.

Comments From the AICPA

The AICPA agreed with our recommendation to eliminate the limited scope provision of ERISA. The AICPA pointed out that it has supported this position since 1978, stating that plan participants cannot be provided the full assurance contemplated by ERISA if the independent accountants' audit excludes certain assets as currently permitted by the limited scope provision.

The AICPA did not take a position on our recommendation on internal control reporting. Rather, it set forth a number of issues that it believes Labor should consider in deciding whether to require plan administrators to report on the effectiveness of internal controls. The AICPA further stated that if Labor determines that the benefits outweigh the costs, explicit auditor reporting on the plan administrator's assessment of plan internal controls is essential. The AICPA stated that the work should be limited to internal controls over financial reporting and should be in accordance with the AICPA's Standards of Attestation Engagements.

The AICPA expressed serious concerns with direct reporting of fraud and serious ERISA violations to Labor because it believes that disclosure of matters other than those affecting the auditor's opinion on the plan's financial statements to those outside the client organization are generally precluded by the auditor's ethical and legal obligation of client confidentiality. We disagree with this view of the auditor's obligation when the plan administrator fails to report fraud and serious ERISA violations. In

this regard, we note that the U.S. Supreme Court has observed that federal courts do not recognize a confidential accountant-client privilege under which accountants may withhold information from federal regulators. We also note that the recently passed Federal Deposit Insurance Corporation Improvement Act of 1991 (Public Law 102-242) requires auditors to disclose certain illegal acts in reports provided to regulators of insured depository institutions.

The AICPA agreed with our recommendation to require peer review, provided that its own current peer review programs are accepted. We agree that Labor should consider current AICPA peer review programs as a practical means of implementing a peer review requirement. These programs meet the peer review requirements of government auditing standards.

The AICPA did not object to our recommendation that audit reports be jointly addressed to plan administrators and participants provided that plan auditors are not responsible for distributing copies of their reports to plan participants.

Expectations of Auditors

The AICPA also cautioned against creating an inappropriate expectation that an audit of the financial statements by the independent public accountant is the primary way to protect plan participants.

Beginning in early 1985, the AICPA initiated a number of projects that addressed growing public concerns about the quality of financial reporting and independent audits. After about 3 years of effort, the AICPA issued 10 auditing standards intended to help close the gap between public expectations of the auditor's responsibility and the auditor's assessment of that responsibility. In part, the new auditing standards expanded the auditor's role in such areas as understanding internal control structures as well as detecting and reporting illegal acts. We believe that our recommendations for expanding plan audit and reporting requirements are consistent with the AICPA's initiatives to enhance the effectiveness of independent audits and the usefulness of audit reports. Implementation of these recommendations would also allow the profession to better meet the public's expectations.

While audits should not be assumed to guarantee protection, they can help regulators protect plan participants' interests. In addition, audits can help plan administrators fulfill their fiduciary duties and comply in all material respects with laws and regulations materially affecting the financial

statements. We believe that the current audit provisions for employee benefit plans do not go far enough in providing protection to participants in the plans and that implementing our recommendations would strengthen audits of plans and reporting by plan administrators.

The AICPA also raised the issue of auditor liability as it relates to increased expectations and new responsibilities, such as reporting on internal controls. We believe that the issue of auditor liability must be considered in the broader context of all professional services provided in this and other industries and should not bar immediate strengthening of plan audits.

Financial Reporting and Audit Requirements for Employee Benefit Plans

This appendix describes the requirements for audits of employee benefit plans. These requirements are delineated by (1) ERISA, (2) implementing Labor regulations, (3) AICPA guidance, and (4) the Financial Accounting Standards Board (FASB) Statement No. 35 on accounting principles.

ERISA requires plan administrators to provide Labor with annual reports and make these annual reports available to plan participants. While ERISA generally specifies how plan administrators are to satisfy the reporting requirement, it also authorizes the Secretary of Labor to prescribe simplified and alternative methods of compliance as the Secretary determines appropriate. By regulation, the Secretary has prescribed such methods which plans may elect to use. As a result, specific audit requirements will vary according to which annual report requirements plan administrators follow.

The requirements outlined in ERISA and the alternatives contained in Labor regulations are similar. For example, consistent with ERISA, Labor regulations require that plans having 100 or more participants obtain an annual audit, which must be performed in accordance with generally accepted auditing standards. These standards are promulgated by the AICPA, which also issues an audit guide to assist auditors in performing plan audits. In addition, ERISA and Labor regulations both require the auditor to opine on the financial statements' consistency with the accounting principles the plan purports to follow.

However, differences also exist between the ERISA and Labor regulation requirements. For example, ERISA requires plans to prepare financial statements in conformity with generally accepted accounting principles. Under Labor regulations, plans may present financial statements on bases other than generally accepted accounting principles so long as any variances from those principles are explained. Also, generally accepted accounting principles vary by type of plan. FASB promulgates these principles for defined benefit pension plans, while the AICPA audit guide describes and recommends specialized accounting and reporting principles for other types of plans.

Annual Report Contents

The annual reports required by ERISA and Labor regulations are generally intended to disclose information about plan operations and are a key control in safeguarding the interests of plan participants and the government. As described below, a plan's annual report generally includes a Form 5500, financial statements, certain schedules, and an audit report. In addition, federally insured defined benefit pension plans must file PBGC Form 1.

Form 5500

ERISA and Labor regulations require that plan annual reports include a Form 5500.¹ The Form 5500 contains general information on a plan's sponsor, funding arrangements, participants, and financial operations. Plan administrators must file a Form 5500 within 7 months of the close of the plan's fiscal year.

Plan Financial Statements

ERISA and Labor regulations generally require that plan annual reports include two financial statements: a balance sheet and an income statement. These statements comprise the core of financial information on a plan's operations. In addition, generally accepted accounting principles specify requirements for the form, arrangement, and content of the financial statements and their notes. ERISA and Labor regulations also require that notes to the financial statements include a description of the plan; priorities for distributing plan assets on plan termination; contingent liabilities, material lease commitments, and other commitments; transactions with parties in interest;² tax status information;³ and any other material necessary to fully and fairly present plan financial statements.

Some ERISA provisions and Labor regulations for alternative reporting differ regarding plan financial statements. For health and welfare plans, ERISA requires a statement of changes in financial position in addition to a balance sheet and an income statement. Labor regulations require that the balance sheet be presented in a form that allows amounts to be compared with those of the preceding year at current value. Labor regulations also require two additional notes not required under ERISA. One of these notes is

¹In addition, certain types of plans are required to include special attachments to the Form 5500. For example, defined benefit pension plan annual reports require an actuarial statement.

²ERISA prohibits transactions involving conflicts of interest or dealings among parties in interest, such as plan fiduciaries, plan employees, or plan service providers.

³A trust established under an employee benefit plan is ordinarily exempt from federal income taxes under the Internal Revenue Code.

to explain the basis of accounting used to prepare the plan's financial statements and describe any variances from generally accepted accounting principles. A second note is to explain any differences between the information contained in the plan financial statements and the financial information reported on the Form 5500. Labor regulations also require a note on plan funding policy. ERISA requires such a note for pension plans but not for health and welfare plans.

PBGC Form 1

The Form 1 (including Schedule A to the Form 1) and Form 1-ES are forms used to report premiums due to PBGC as required by sections 4006 and 4007 of ERISA, as amended, and PBGC's Payment of Premiums regulations (29 C.F.R. part 2610).

Accounting Requirements

ERISA and Labor regulations for alternative reporting differ in terms of the accounting basis they allow plans to use in recording financial activities. ERISA requires that plan financial statements be presented in conformity with generally accepted accounting principles, which require that accrual accounting be followed. Accrual accounting is the method of recognizing revenue as services are rendered and expenses as they are incurred independently of the time when funds are received or expenditures are made. FASB Statement No. 35 established these principles for defined benefit pension plans. The AICPA audit guide includes descriptions of, and recommendations on, specialized accounting and reporting principles for other types of plans.

In contrast, Labor regulations do not specifically require that generally accepted accounting principles, and thus accrual accounting, be used. Instead, a plan electing to follow Labor's alternative method of reporting may present the financial statements on a cash basis; that is, income and expenses may be recorded when cash is received and disbursed. While Labor regulations do not require accrual accounting, they do require plan financial statements to (1) include a note which explains the basis of accounting used to prepare the statements and (2) describe any variances from generally accepted accounting principles. Further, auditing standards require that the audit report discuss the basis of accounting for financial statements not prepared in conformity with generally accepted accounting principles.

ERISA Schedules

ERISA and Labor regulations require that plan annual reports include certain schedules, referred to as ERISA schedules, to the extent that they apply to a plan's operations.

Table I.1 shows the schedules that are required.

**Table I.1: Supplemental Schedules
Required by ERISA and Labor
Regulations**

Schedule	ERISA (statutory method)	Labor regulations (regulatory method)
Assets held for investment purposes	X	X
Party-in-interest transactions	X	X
Loans or fixed income obligations in default or classified during the year as uncollectible	X	X
Leases in default or classified during the year as uncollectible	X	X
Reportable transactions ^a	X	X
All assets acquired and disposed of during the plan year		X
Assets and liabilities at current value aggregated by categories and in comparative form	X	
Receipts and disbursements aggregated by general sources and applications	X	

^aA "reportable transaction" is a transaction which involves (1) more than 3 percent of the current value of the plan's assets or (2) a series of transactions aggregating 3 percent or more of the current value of the plan's assets. For plan years beginning on or after January 1, 1988, this 3-percent criterion was changed to 5 percent for plans filing under Labor regulations.

Labor regulations exempt certain types of plan assets from the ERISA schedules of assets held for investment, assets acquired and disposed of, and in some instances, reportable transactions. Exempted assets and transactions include

- bank certificates of deposit with a maturity of less than 1 year,
- units of participation in a bank common or collective trust or an insurance company pooled separate account,
- securities purchased from a broker-dealer and listed on a national securities exchange,
- debt obligations of the United States or any agency of the United States,
- interests issued by a company registered under the Investment Company Act of 1940, and
- investments reported in other ERISA schedules.

Auditing Requirements

Consistent with ERISA, Labor regulations require that annual reports for plans having 100 or more participants include an audit report prepared by a qualified independent public accountant. ERISA requires that the audit report include an opinion as to whether or not the financial statements are fairly presented in conformity with generally accepted accounting principles on a basis consistent with that of the preceding period. Labor regulations also require an opinion on the fairness of the financial statements, but, since statements need not be prepared in accordance with generally accepted accounting principles, auditors are required to opine on the statements and the basis on which they are prepared. In addition, ERISA and Labor regulations require that the audit report include an opinion on the fairness of ERISA schedules in relation to the plan's financial statements as a whole.

Auditing Standards

ERISA and Labor regulations require that plan audits be performed in accordance with generally accepted auditing standards, which are promulgated by the AICPA. These standards cover auditor training and proficiency, independence, due professional care, planning and supervision, evaluating internal controls, obtaining sufficient evidence, reporting on the financial statements' compliance with generally accepted accounting principles, reporting on the consistent application of accounting principles, reporting adequate informative disclosures, and expressing or disclaiming an opinion on the financial statements taken as a whole.

The AICPA also publishes an industry audit guide to assist auditors in performing and reporting on audits of plan financial statements. The guide includes recommended auditing procedures and information on ERISA and related Labor regulations. Although auditors are not required by either ERISA or Labor regulations to follow the AICPA audit guide's suggested procedures, AICPA members may have to justify departures from the guide's recommendations.

Audits conducted during the period we examined were subject to the guidance provided by the 1983 edition of the AICPA Audit and Accounting Guide for Employee Benefit Plans, which discussed the following topics in detail:

- planning the examination;
- study and evaluation of internal accounting controls;
- investments;

- contributions received and related receivables;
- benefit payments;
- participants' data and plan obligations; and
- other auditing considerations (for example, contingencies, tax status, and administrative expenses).

Provision for Limited Scope Audits

ERISA and Labor regulations allow certain plan assets to be excluded from an auditor's scope of examination. Specifically, plan administrators may exclude any assets held and transactions executed by institutions, such as banks and insurance carriers, that are regulated, supervised, or subject to periodic examination by a state or federal agency. For such limited scope audits, the auditor is to obtain a certification from the financial institution or insurance carrier as to the completeness and accuracy of the information and may disclaim an opinion in the audit report.

Comments From the Department of Labor

U.S. DEPARTMENT OF LABOR

SECRETARY OF LABOR
WASHINGTON, D.C.

DEC 12 1991

Mr. Donald H. Chapin
Assistant Comptroller General
U. S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Chapin:

We have reviewed the draft report prepared by the General Accounting Office (GAO) regarding reporting and audit issues related to employee benefit plans. The GAO draft report focusses primarily on a follow-up to the 1989 audit report prepared by the Department of Labor's (the Department) Office of the Inspector General and some of the more recent actions taken by the American Institute of Certified Public Accountants (AICPA); however, it does not relate the activities undertaken concurrently by the Department's Pension and Welfare Benefits Administration (PWBA), since no exit conference was held at which we could have described our efforts in this area. The Department has also devoted much time to examining these issues over the past several years and designing programs to address them and we believe that we have made a great deal of progress in this area. Therefore, in addition to offering comments on the recommendations proposed by GAO (see Enclosure I), we would like to use this opportunity to provide an update on the audit-related initiatives which the Department has undertaken (see Enclosure II). Also, we have annotated a few technical corrections in the enclosed pages from the draft report (see Enclosure III).

It is important to explain at the outset that we have concluded, in conjunction with the Solicitor of Labor, that we do not have statutory authority to implement substantive changes in the scope of the audit to be performed by the auditor engaged by the plan, the form in which the auditor reports, or the educational requirements for accountants. In fact, section 103(a)(3)(A) of the Employee Income Security Act of 1974 (ERISA) specifically defers to the use of Generally Accepted Auditing Standards (GAAS) and Generally Accepted Accounting Principles (GAAP) in the preparation and audit of plan financial statements. Accordingly, we have considered the draft report's recommendations primarily in the context of possible legislation.

Finally, since several of GAO's recommendations relate directly to decisions which can be made only by the American Institute of Certified Public Accountants (AICPA), we assume that a copy of this draft report has been shared with them.

Appendix II
Comments From the Department of Labor

We would be pleased to discuss these comments with members
of the GAO audit team.

Sincerely,

Lynn Martin
LYNN MARTIN

Enclosures

Enclosure I

DEPARTMENT OF LABOR (DOL) RESPONSE TO THE RECOMMENDATIONS
CONTAINED IN THE GAO DRAFT REPORT ENTITLED
"IMPROVED PLAN REPORTING AND CPA AUDITING
INCREASE PROTECTION UNDER ERISA"

See page 24.

GAO Recommendation No. 1: DOL [should] reconsider the nine audits and refer the auditor to professional and/or licensing authorities if deemed appropriate. (pg. 36)

DOL Response: The audits identified by GAO are now five to six years old. The AICPA's Professional Ethics Division has a significant backlog of referrals from the Department of Labor's Pension and Welfare Benefits Administration (PWBA) that still need to be resolved. Accordingly, as an alternative approach, PWBA will review the more recent Form 5500 filings and the audit reports prepared by the accounting firms in question to determine if professional accounting and auditing deficiencies still exist. If so, these more recent audits can be referred to the AICPA's Professional Ethics Division for further investigation.

See page 29.

GAO Recommendation No. 2: The AICPA [should] change its audit guide to

-- discuss the importance of audits in protecting plan participants;

See page 29.

-- discuss the need for auditors to have specialized industry knowledge needed to successfully perform plan audits;

See page 29.

-- identify and clearly describe requirements for specific schedules and financial statement footnotes. These requirements should include those for statements prepared under the statutory and regulatory methods, as well as GAAP requirements. (pgs. 43-44)

DOL Response: We believe that this basic information currently is incorporated in the revised AICPA audit and accounting guide. In both the Preface and Chapter 1, reference is made to specialized information and knowledge that the auditor needs relating to employee benefit plans. We also note that Appendix A, page 117, paragraphs A.41 and A.42 provide detailed information on the financial statements, footnotes, and supplemental schedules required under both the statutory and regulatory methods of filing.

See page 29.

GAO Recommendation No. 3: The AICPA [should] communicate to its membership the results of (1) its investigations of the 10 audits referred by Labor, with which the AICPA found problems, and (2) the results of future investigations of deficient plan audits. (pg. 44)

DOL Response: We agree and would like to note that we, too, have urged the AICPA to publicize the results of its investigations of employee benefit plan audits referred by PWBA.

See page 40.

GAO Recommendation No. 4: Congress [should] amend ERISA to eliminate the provision that permits plan administrators to direct audit firms to perform limited-scope audits. (pg. 59)

DOL Response: The Department of Labor is on record as being in favor of eliminating the limited-scope audit exemption provided under 29 CFR 2520.103-8. In its 1990 ERISA legislative proposal, the Department recommended the repeal of the limited-scope exemption for plan audits, encouraging instead, the use of the "single audit" approach that is currently available under Generally Accepted Auditing Standards (GAAS). The Department's current legislative package is now in the final stages of consideration by the Administration. The issue of repeal of the limited-scope audit exemption is among those being considered.

Recommendation No. 5: The Department of Labor [should] promulgate regulations to require plan administrators to report on the effectiveness of plan internal controls and auditors to report on plan administrators' assessment of these controls. Reports prepared by plan administrators should be included in plan annual reports submitted to Labor and should

See page 40.

-- describe actions taken to establish and maintain an effective system of internal controls.

See page 40.

-- contain the plan administrator's assessment of the effectiveness of the plan's internal control structure,

See page 40.

-- identify material control weaknesses that have not been corrected, and

See page 40.

-- contain the signature of the plan administrator. (pg. 59)

DOL Response: While PWBA agrees that significant internal control weaknesses can lead to fraud and abuse of plan assets, the approach recommended in GAO's draft report may well result in the reporting of internal control weaknesses that are not significant. Requiring a separate report on internal controls will be costly to plans and plan sponsors, and may inundate PWBA with thousands of reports which do not contain significant internal control weaknesses. Furthermore, both the revised AICPA audit guide and Generally Accepted Auditing Standards provide for

Appendix II
Comments From the Department of Labor

the review of and reporting on internal controls. Significant internal control weaknesses may be reported in the context of the audit report or disclosed in notes to the financial statement.

PWBA is currently assessing alternative approaches for the identification and reporting of significant internal control weaknesses. One alternative would require plan administrators to indicate on the plan's annual report filing (Form 5500) when significant internal control weaknesses have been identified. This information could then be identified, and followed-up on, in conjunction with PWBA's automated targeting efforts. An advantage of this approach is that it can be accomplished without statutory amendment.

Finally, the Department also notes that it does not have the authority under current law to adopt this recommendation without statutory changes to the extent that it requires a change in the scope of the existing audit.

Recommendation No. 6: The Department of Labor [should] require that plan auditors

- report fraud and serious ERISA violations promptly after discovery if plan administrators do not do so,
- participate in a peer review program which assesses the quality of at least one plan audit, and
- address their report jointly to plan administrators and participants. (pg. 60)

DOL Response: With respect to direct reporting, the Department is considering whether plan administrators should be required to report to the Secretary of Labor information related to certain criminal acts involving employee benefit plans covered by ERISA. The draft GAO report does not define its term "serious violations" and without further explanation, there is a concern that accountants may be asked to make determinations outside of their area of expertise, e.g., legal decisions involving other provisions of the statute. Also, the Department has reservations about implementing a wider range of direct reporting outside of the framework of the Form 5500 annual report and PWBA's new automated ERISA Information System. Resources used to administer a program of direct notification of a variety of alleged violations would have to be diverted from the review of plan filings and investigative casework currently being performed. We do not see a benefit commensurate with such a shift in resources.

The Department has supported a requirement that accountants conducting ERISA audits obtain a peer review every three years to remain qualified to perform such audits. A similar provision was

See page 40.

in the legislation introduced into the 101st Congress in November 1990. It is also being considered along with other pension issues as part of the Department's current legislative package now in the final stages of consideration by the Administration.

In regard to these first two components of this recommendation, the Department notes that under current law, it does not have the authority to adopt such recommendations without statutory changes.

The Department agrees with the recommendation that audit reports be addressed to plan participants. Under the revised AICPA industry audit guide and Generally Accepted Auditing Standards, plan auditors are permitted to address audit reports to both plan administrators and plan participants. The Department will explore whether this change could be accomplished through the regulatory process if the instructions for the Form 5500 were amended to require that the report be addressed to the plan administrator on behalf of the participants and beneficiaries. We note that the impact of this recommendation to remind accountants for whom the audit is being performed is more symbolic than substantive.

Recommendation No. 7: If the Department of Labor does not promulgate regulations to implement these recommendations, ...the Congress [should] amend ERISA to achieve these objectives. (pg. 60)

DOL Response: As noted above in our responses to specific recommendations, the Department is already in the process of addressing many of these concerns.

See page 41.

Enclosure II

**DEPARTMENT OF LABOR INITIATIVES
RELATED TO REPORTING AND ACCOUNTING ISSUES**

To better deal with the issues raised by the OIG and to enhance the accounting and auditing expertise within the agency, PWBA established an Office of the Chief Accountant (OCA) in 1988 to provide a centralized unit which would focus on accounting and auditing related issues, including the quality control issues discussed in the OIG's 1987 study on ERISA plan audits. OCA's first efforts were directed in two main areas: (1) developing an internal quality control program relating to the review of Form 5500 annual reports and their accountant's opinions and (2) establishing an on-going relationship with the professional accounting organizations, such as the AICPA and the Financial Accounting Standards Board, to improve employee benefit plan audit procedures and practices. Of particular note during FY 1989 was the development and implementation of the procedures for referral to the AICPA and state Boards of Accountancy of substandard audits of employee benefit plans for investigation and action.

During this same time frame, PWBA implemented two major program initiatives which have a direct bearing on plan audits: a new computer database system to enhance the Agency's ability to effectively target employee benefit plans with the highest potential for ERISA violations and a reporting compliance program under ERISA Section 502(c)(2) to review, reject if inadequate, and assess civil penalties with respect to the plans' annual filings including their accountant's reports.

The ERISA Information System serves as the central source of information on the financial status and activities of the pension plans within PWBA's jurisdiction and on welfare plans with more than 100 participants. Through this system (which utilizes the information from the Form 5500 series of reports which are required to be filed annually by plan administrators), PWBA is able to subject financial data and information on plan activities to a comprehensive automated analysis to determine whether there are any indications of violations within 30 days of receipt by the Internal Revenue Service of the filing. The initial screening of all Form 5500 reports is accomplished through a system of over 130 computerized edit checks. As a result of these automated edit tests, over 318,000 plan administrators received notices from the Federal government that there were errors or missing items in their Form 5500s for the 1988 plan year. Approximately 309,000 such notices were sent to plan administrators for the annual reports covering the 1989 plan year.

In addition, PWBA uses the results of the edit checks as the foundation of a reporting compliance program under which the Agency may reject an annual filing if the Form 5500, or its accompanying accountant's opinion, is considered to be inadequate. Under a recent amendment to section 502 of ERISA, PWBA is now able to assess civil penalties of up to \$1,000 per day against plan administrators for missing, late or deficient reporting under the statute.

During FY 1990, PWBA's accounting, enforcement, policy and regulatory offices explored legislative initiatives to resolve those recommendations made by the OIG regarding plan audits which required legislative amendments to ERISA. During this period, a task force appointed by Secretary of Labor Elizabeth Dole was conducting a review of all Departmental enforcement strategies. After that study was completed in September 1990, the Department also concluded that changes to ERISA were needed to implement these enforcement initiatives, including repeal of the limited scope audit provisions of the statute and the implementation of peer review requirements. As a result of these efforts, ERISA enforcement legislation was introduced in November 1990, although the 101st Congress adjourned without taking action on the legislation.

In FY 1991, PWBA's Office of the Chief Accountant (OCA) made significant progress in a number of key operational areas related to the recommendations of the GAO draft report:

- (1) OCA worked extensively with the American Institute of Certified Public Accountants (AICPA) in the revision of the AICPA's guide for the audit of employee benefit plans which was issued in March 1991;
- (2) OCA participated with the AICPA in planning and presenting an Annual Employee Benefit Plans Update Conference; produced audit risk alerts and checklists for accounting practitioners and continuing professional education materials for accountants and other professionals who perform services for employee benefit plans; and has urged the AICPA to develop other opportunities for professional training in the ERISA area (a new self-study course will be available in mid-November 1991 and, in May 1992, the AICPA will present a lecture series in a number of major cities to provide training on the revised industry guide);
- (3) OCA conducted in-house reviews of 1200 accountant's reports submitted with ERISA annual reports for compliance with professional standards;
- (4) OCA initiated a program of on-site reviews of Independent Public Accountant audit work papers and, in

FY 1991, conducted 26 such reviews based on the results of the above mentioned in-house review of accountant's opinions and referrals from PWBA field offices of substandard work identified during investigations of employee benefit plans;

(5) OCA made extensive use of new enforcement authority under ERISA Section 502(c)(2) against plan administrators who failed to obtain correction of deficient audit work. In FY 1991, OCA issued 692 letters rejecting ERISA report filings and imposed penalties of \$5.9 million against plan administrators who did not demonstrate a reasonable cause for failing to obtain adequate audits. In many instances, the plan administrators are seeking repayment from the plan auditor; and

(6) By the end of FY 1991, OCA made a cumulative total of 105 referrals to the AICPA's Professional Ethics Division and 10 referrals to state Boards of Accountancy. Of the 37 cases closed to date, the AICPA recommended Trial Board action for 11 cases and required corrective actions and continuing professional education in 17 cases. In some instances, AICPA members have been required to submit additional work products for review after their training requirements have been fulfilled. The AICPA has reported that in the period from May 1986 through August 1991, PWBA referred twice as many cases as any other government agency, and that the AICPA may expand its Professional Ethics Committee to have a subordinate unit dealing specifically with ERISA referrals.

In September 1991, the Department's Policy Review Board considered a refined overall ERISA legislative package, which also included other enforcement issues, as part of the Department's legislative program for FY 1992. ERISA issues, such as the repeal of the limited-scope audit exemption and peer review requirements, are again part of the Department's legislative proposal for FY 1992. The Department expects that this legislative proposal dealing with ERISA accounting issues will be introduced into the 102nd Congress in early 1992. In addition, PWBA continues to work on an on-going basis with the AICPA in areas such as (1) the continuing professional education for members of the accounting profession who conduct employee benefit plan audits and (2) the application of sanctions against those practitioners who perform substandard audit work.

In summary, in the intervening years since the OIG's first study regarding employee benefit plan audits, we believe that aggressive enforcement in the accounting area and on-going liaison with the accounting profession has raised the consciousness of benefit plan auditors and has encouraged compliance with the requirements of ERISA. PWBA's reporting compliance and quality control programs have heightened awareness of the reporting and auditing requirements contained in ERISA. These programs have increased

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Comments From the Department of Labor

the visibility of the Department's efforts to ensure accurate reporting of plan activities and that plan audits meet professional accounting and auditing standards. The rejection of plan filings, imposition of Section 502(c)(2) civil penalties, and referral of deficient professional work by accountants to licensing authorities are indicative of the Department's commitment to strong enforcement of ERISA's reporting requirements.

Comments From the American Institute of Certified Public Accountants

AICPA

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December 17, 1991

Mr. Donald H. Chapin
Assistant Comptroller General
Accounting and Financial Management
U.S. General Accounting Office
441 G Street, N.W.
Washington, DC 20548

Dear Mr. Chapin:

The American Institute of Certified Public Accountants (AICPA) appreciates the opportunity to comment on the GAO's October 1991 Draft Report, "Employee Benefits: Improved Plan Reporting and CPA Audits Can Increase Protection Under ERISA" (Draft Report). This letter sets forth our general comments on the Draft Report; the attachment includes our comments on GAO's specific recommendations.

The AICPA is the national professional association of certified public accountants (CPAs) representing more than 300,000 CPAs in public practice, industry, government, and education. Over the years, the AICPA has been a principal force in the development of professional standards, guidance, and educational programs designed to improve the quality of services provided by CPAs. Throughout its more than 100 years of service to its members and the public, the AICPA has become widely recognized as the authoritative voice of the profession in the United States.

AICPA Supports Efforts to Assure That Plan Participants Receive Their Benefits

On June 13, 1990, representatives of the AICPA testified before the Subcommittee on Oversight of the Committee on Ways and Means, U.S. House of Representatives, on the subject of enforcement and administration of the Employee Retirement Income Security Act of 1974 (ERISA).

In our statement, we said:

We gather here today in a noble cause. Secretary of Labor Elizabeth Dole captured its essence in a recent speech. Referring to pension security, she said:

We will strive to ensure that every participant receives the benefits to which he or she is entitled.

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Her pledge, I am sure, would be seconded by every one of us, and, most certainly, by the members of the AICPA. Her goal is important to the vigor of both our economic and democratic systems.

In that same speech, Secretary Dole said:

We have been working closely with the American Institute of Certified Public Accountants on all audit related issues, including compliance testing... I am pleased to report that our negotiations with the AICPA on this matter are progressing constructively.

We want to reiterate our strong commitment to helping the Department of Labor (DOL) and the Internal Revenue Service (IRS) in assuring that every participant receives the benefits to which he or she is entitled.

We also stated (in our June 13, 1990 testimony) that the DOL and IRS rules, in theory, do protect the interests of the American worker. Vigorous enforcement of those rules is the key to turning that theory into reality. We recommended that Congress be receptive to requests from the IRS and DOL to enhance their capability to insightfully review returns and reports, and to quickly send out well trained examiners in appropriate circumstances.

Independent Accountant's Responsibility Under Generally Accepted Auditing Standards (GAAS)

The independent accountant's objective and responsibility, under GAAS, is to express an opinion on whether the financial statements of an entity are fairly presented in accordance with generally accepted accounting principles and are free from material misstatements, whether caused by fraud or error. In so doing, the independent accountant gives reasonable assurance to the users of those statements that the financial information including total assets and liabilities reported by the entity is credible.

An audit of financial statements conducted in accordance with GAAS is not the only means of assuring compliance with the reporting provisions of ERISA. Under the law, plan administrators, the IRS, and the DOL have the responsibility to assure compliance with ERISA's provisions. The annual report and the financial statements prepared by the plan administrator and the independent accountant's report contributes to the monitoring activities of these parties and agencies. An audit is an important discipline on the financial

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information reported by the plan administrator of the covered plans, but it is not designed to assure compliance with all legislative and regulatory requirements that relate to employee benefit plans.

The AICPA supports cost beneficial efforts and suggestions to increase the protection of plan participants. However, we caution against creating an inappropriate expectation that an audit of the financial statements by the independent accountant is the primary protection.

With respect to the public's understanding of the role of the independent accountant in the reporting process under ERISA, we are concerned that the title of the GAO's Draft Report, as well as and some of the statements made therein, may create an unrealistic expectation in the mind of members of Congress, government officials, plan participants, and others relative to the role and work of independent accountants when they are engaged to audit a plan's financial statement in accordance with GAAS.

If the Congress and the DOL wish the independent accountant to expand the scope of work beyond an audit of the financial statements of a covered plan to include a report on compliance with specified laws and regulations, they must be explicit in what it requires. The laws and regulations and the criteria against which the independent accountant would be required to test and report must be clearly defined and specified. For example,

- ♦ they must relate to financial matters within the competence of independent accountants;
- ♦ they must establish requirements with sufficient precision to permit objective evaluation of plan compliance; and
- ♦ there must be reasonable criteria to measure compliance.

Of course, before they set out on this path, the Congress and the DOL must also recognize that any additional work required for the plans may entail significant costs. However, if they believe that this increased scope is desirable and beneficial, we will work with the DOL to develop the necessary agreed-upon procedures that the independent accountant would apply in testing such compliance and issuing the appropriate report in accordance with applicable attestation standards issued by the AICPA.

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AICPA Efforts to Assist Its Members

Auditing standards and procedures, audit quality controls, and individual auditor performance are essential elements in achieving the objective of an audit conducted in accordance with GAAS. To assist its members in achieving that objective, the AICPA has established a number of inter-related programs to strengthen standards of auditor performance. In this respect--

- ♦ the AICPA has adopted and continuously augments auditing standards and other types of auditor guidance;
- ♦ the AICPA has adopted quality control standards that are required to be followed by all members who perform audits;
- ♦ for more than ten years, the AICPA's Division for CPA Firms has monitored compliance by its members with quality control and auditing standards through a comprehensive program of peer reviews;
- ♦ more recently, the AICPA has adopted a program of mandatory quality reviews for all members in public practice who provide audit and accounting services; and
- ♦ the AICPA administers programs as part of an overall system--which includes state boards of accountancy, state CPA societies, and the courts--to deal with allegations of individual misconduct.

The Draft Report summarizes the specific steps taken by the AICPA to address the findings of the DOL's Inspector General (IG) relative to his review and findings of plan audits under ERISA.

Unreasonable Expectations May Lead to Increased Unwarranted Litigation Against Independent Accountants

Unreasonable expectations, coupled with the expanded role for independent accountants that the GAO is recommending in the Draft Report, may increase the profession's unwarranted legal liability. The current judicial system and litigious environment is threatening our ability to provide the services that public policy makers deem so important for the protection of the public. The profession is not hesitant to accept and fulfill its public responsibilities, but we do so in a very litigious atmosphere. We do not seek relief from those situations in which we are at fault, but rather relief from a disproportionate system in which we are held financially liable for the wrongdoing of others, specifically, the joint and several liability standard that encourages plaintiffs to proceed

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against the defendant with the deepest pockets. We seek your support in urging the Congress to adopt a proportionate liability standard--one that holds a defendant responsible for the consequences of his or her actions, and not the harm caused by others. We are seeking fairness, not special treatment. Such fairness is especially crucial when the services provided by independent accountants are expanding to--as recommended by GAO--meet newly-identified needs, such as reporting on internal control and testing for compliance with laws and regulations.

The GAO's Findings of Some Non-Adherence to Auditing Standards

In the Draft Report, the GAO cites instances of non-adherence to auditing standards in the audits it reviewed. The AICPA takes most seriously any allegation of poor audit quality. In December of 1987, when the DOL's IG issued his report and identified certain deficiencies, we arranged a meeting shortly after issuance of that report with representatives of the DOL to discuss the report and determine what, if anything, the AICPA could do to address those matters discussed in the report. Following that meeting, a new AICPA committee was established to improve and expedite guidance in this area and to work with the DOL to address appropriate matters of mutual interest and to deal with mutual problems.

The Draft Report summarizes the many steps the AICPA has taken--and continues to take--to improve the quality of audits of plan financial statements. The steps we have taken are designed to improve the quality of work in the future. If the DOL believes some benefit will be derived from referring additional audits, we would welcome them.

Conclusion

Audit deficiencies, if and when they occur, do not necessarily correlate with plan mismanagement or beneficiary risk. For example, assets available for benefits are not adversely affected by the lack of a footnote disclosure in the administrator's report or nonperformance of an audit procedure by the independent accountant.

The "at risk" status of plan beneficiaries is overwhelmingly influenced by factors beyond the scope of audits of financial statements or the ability of independent accountants to influence. The most prominent of these factors is the quality of investment judgements by plan administrators or investment fiduciaries.

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The AICPA will continue to work with the DOL to address areas of mutual interest. The AICPA takes any allegations concerning poor performance by independent accountants extremely seriously. Nevertheless, we are confident that the public may rely on the independent accountants' reports to provide the assurance plan participants deserve regarding the financial status of the plan.

The attachment includes our comments on the specific recommendations.

Sincerely,



Gerald A. Polansky
Chairman of the Board

Attachment

Appendix III
Comments From the American Institute of
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ATTACHMENT TO AICPA'S DECEMBER 17, 1991 LETTER ON
GAO'S OCTOBER 1991 DRAFT REPORT,
"EMPLOYEE BENEFITS: IMPROVED PLAN REPORTING AND
CPA AUDITS CAN INCREASE PROTECTION UNDER ERISA"

Chapter 2

GAO Recommendation

See page 24.

DOL should reconsider the nine audits and refer the auditor to professional and/or licensing authorities if deemed appropriate.

AICPA Comment

As stated in our letter, the AICPA takes seriously any allegations concerning poor performance by auditors. If the DOL determines that benefits greater than the related costs will be derived by referring the additional nine audits, the AICPA Ethics Division will review and investigate the allegations and report its findings to the DOL.

Chapter 3

GAO Recommendation

See page 29.

Audit guide [AICPA Audit and Accounting Guide, "Audits of Employee Benefit Plans"] should be changed to discuss the importance of audits in protecting plan participants.

AICPA Comment

The audit requirement included in ERISA is an important part of the total process designed to protect plan participants. The audit of the financial statement provides reasonable assurance to the users of the plan's financial statements--including plan participants--that the financial information including total assets and liabilities reported by the plan administrator is relevant and credible. Accordingly, we will expand the discussion in the audit guide to emphasize that the DOL and plan administrators, on behalf of plan participants, rely on the audit to provide the assurances noted above.

See page 29.

GAO Recommendation

Audit guide [AICPA Audit and Accounting Guide, "Audits of Employee Benefit Plans"] should discuss the need for auditors to have specialized industry knowledge to successfully perform plan audits.

AICPA Comment

Generally accepted auditing standards require auditors to obtain specialized industry knowledge when conducting an audit of the financial statements. Specifically, Statement on Auditing Standards (SAS) No. 22, "Planning and Supervision," provides such guidance. The planning chapter of the audit guide refers the reader to SAS No. 22. We believe that audit guides need not restate all of the SASS. Nevertheless, we will consider expanding the discussion to address this recommendation.

GAO Recommendation

See page 29.

Audit guide [AICPA Audit and Accounting Guide, "Audits of Employee Benefit Plans"] should identify and clearly describe requirements for specific schedules and financial statement footnotes. These requirements should include those for statements prepared under the statutory and regulatory methods, as well as GAAP requirements.

AICPA Comment

We agree that Table I.1 in the Appendix of the Draft Report, "Supplemental Schedules Required by ERISA and Labor Regulations," may be helpful to auditors, and we will consider including it in the audit guide to supplement the existing guidance contained in Exhibit A-4, which discusses the general audit and filing requirements. Representatives of the DOL have informed us that no plan administrator currently files reports using the statutory method permitted by ERISA.

GAO Recommendation

See page 29.

The AICPA should communicate to its membership the results of current and future investigations.

AICPA Comment

The nature and extent of the findings based on our ethics investigations was discussed at the AICPA Employee Benefit Plans Conference on December 12-13, 1991. They will also be covered in a future article in the Journal of Accountancy. The findings are not significantly different from the IG's findings that have been widely publicized. Nevertheless, we will consider publishing the results of future investigations by the AICPA Ethics Division.

Chapter 4

GAO Recommendation

Congress should amend ERISA to eliminate the provision that permits plan administrators to direct audit firms to perform limited scope audits.

AICPA Comment

We support the recommendation that the Congress amend ERISA to eliminate the limited scope audit exemption. The constraint on the utility of audits results wholly from current regulations and practices of plan administrators.

The AICPA is on record, beginning in 1978, as stating that plan participants cannot be provided the full assurance contemplated by ERISA if the independent accountant's audit is restricted to exclude assets held in a bank or similar institution or an insurance carrier as permitted by Section 103(a)(3)(C). If the Congress wishes to remove this constraint on the utility of required audits, it need only eliminate the authority to impose limitations on the scope of audit.

GAO Recommendation

DOL should promulgate regulations to require plan administrators to report on the effectiveness of plan internal controls and auditors to report on plan administrators' assessment of these controls.

AICPA Comment

In deciding whether to require plan administrators to report on the effectiveness of internal controls and require auditors' association therewith, the DOL should, among other things, thoroughly consider:

- ♦ the cost of complying and benefits to be derived;
- ♦ the size and organizational structure of plans;
- ♦ the definition and scope of the meaning of "internal control structure"; and
- ♦ the extent that plan internal control structures exist under the direct control of plan administrators, or exist at third-party service organizations, custodians, or other external entities used by plan administrators to perform various aspects of plan operations.

See page 40.

See page 40.

If the DOL determines that the benefits of reporting on the effectiveness of the internal control structure outweigh the costs, we believe that explicit auditor reporting on the plan administrator's assessment of plan internal control structure, accompanied by a level of work to support that reporting, is essential. Further, the auditor's work and reports on internal control should be limited to internal controls over financial reporting and should be in accordance with the Standards for Attestation Engagements.

GAO Recommendation

DOL should require plan auditors to report fraud and serious ERISA violations promptly after discovery if plan administrators do not do so.

AICPA Comment

The AICPA agrees that the plan administrator has the primary responsibility to report matters to plan participants and the DOL. The auditor's vehicle for reporting outside the plan is the auditor's report on the financial statement. With respect to fraud and serious ERISA violations, auditors, in accordance with GAAS, currently have an affirmative responsibility to expand their procedures when they become aware of information indicating that an illegal act has or may have occurred. These responsibilities include determining whether it is likely that an illegal act has occurred and, if so, the possible effect on the financial statements. These responsibilities also include making inquiries of plan management above those involved, if possible.

If the illegality is not inconsequential and the plan administrator does not take appropriate action (which may include required notification to the DOL), an appropriate course of action to be taken by the auditor may be to resign.

The AICPA has serious concerns with direct reporting by independent auditors of noted ERISA violations to the DOL because disclosures of matters other than those that affect the auditor's opinion on the plan's financial statements to those outside the client organization are generally precluded by the auditor's ethical and legal obligation of client confidentiality. If the plan administrator must report to the DOL ERISA violations and does not, the auditor would ordinarily lose confidence in management's integrity and would normally resign from the engagement. The Securities and Exchange Commission (SEC) currently requires the filing of a Form 8-K for a change in auditor which includes reasons for the change. The DOL may wish to consider requiring the filing of a similar form whenever a plan changes its auditor.

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GAO Recommendation

Auditors should participate in a peer review program which assesses the quality of at least one plan audit.

AICPA Comment

There are three AICPA practice-monitoring programs. Two have existed since 1977: the peer review programs of the SEC Practice Section (SECPS) and of the Private Companies Practice Section (PCPS) of the AICPA Division for CPA Firms. The third, the quality review program carried out in a partnership with state CPA societies, was organized in 1988 based on the success of those two peer review programs. A firm whose partners and employees wish to remain members of the AICPA must participate in one of those three programs. (The SECPS peer review program was made mandatory in January 1990 for all firms that audit one or more SEC clients, as defined.)

More than 6,600 firms are members of the SECPS, the PCPS, or both Sections. They represent approximately half of the roughly 150,000 AICPA members in public practice. The other half practice in about 39,000 practice units. Over 16,000 of these units have audit clients. Although the AICPA does not yet have hard data, we believe that the large majority of audits of U.S. companies, public and private, are carried out by firms that are members of the SECPS or the PCPS.

Recognizing the public interest in audits of employee benefit plans conducted pursuant to ERISA, each practice-monitoring program has adopted requirements designed to provide added assurance about the quality of ERISA audits. Both the SECPS and the PCPS have adopted requirements mandating the selection of at least one ERISA audit for review in every SECPS or PCPS peer review.

The Quality Review Program's Executive Committee has taken a somewhat different approach and has adopted an interpretation of the program's Standards that concludes as follows:

Regulatory and legislative developments during 1990 have made it clear that there is a significant public interest in audits conducted pursuant to the Employee Retirement Income Security Act of 1974. Accordingly, greater weight should be given in the engagement selection process on on-site reviews to those audits if the firm performs such engagements.

The Quality Review Program's Executive Committee took this slightly different approach because of the importance, cost, and difficulty of carrying out reviews of thousands of firms every three years. The Committee fears that various government agencies could mandate review of audits of entities that come under their surveillance. This would increase the cost of carrying out reviews substantially and, as a result, might jeopardize support within the profession

for this unprecedented program. The Committee believes that a review of a firm's practice on a sampling basis should provide adequate assurance that persons who perform ERISA audits are adequately trained and supervised to conduct such audits in conformity with applicable requirements.

We make these observations for your consideration because, although we support mandatory quality reviews of all public accounting firms that audit employee benefit plans, we would not be able to support regulation that would supplant the standards, procedures, and guidelines that we have developed as a result of extensive and expensive experience. Our programs are working. We believe the DOL can rely on those programs and on the standards and procedures that govern them. Additionally, specific regulation would only make it more difficult to carry out an effective, self-regulatory practice-monitoring program.

We recommend that the GAO suggest that the DOL accept the Institute's programs and discourage the issuance of new, costly and unnecessary regulations.

GAO Recommendation

Auditors should address their reports jointly to plan administrators and participants.

AICPA Comment

The AICPA would not object to the DOL requiring auditors to address jointly their reports to plan administrators and participants and beneficiaries, so long as it is made explicit in any such requirement that auditors would not have a responsibility to distribute copies of their reports to all participants and beneficiaries, which would be impractical and costly. It should be noted that plan administrators currently are not required to send copies of audited plan financial statements to all plan participants and beneficiaries; however, copies may be provided to them by the plan administrator upon request.

* * * * *

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